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Improper Corporate Payments: The Second Half of Watergate†

You don't suppose you can run a railway in accordance with the statutes, do you?

Cornelius Vanderbilt

RONALD P. KANE*
SAMUEL BUTLER, III**

INTRODUCTION

One of the unforeseen consequences of what Spiro Agnew ruefully described as the "post-Watergate morality"[1] has been the discovery that American corporations have made millions of dollars of questionable or illegal corporate payments. Included among these payments have been illegal domestic and foreign campaign contributions, secret bribes to foreign government officials, kickbacks to foreign and domestic customers, and various types of questionable or illegal commission payments to commercial agents and consultants abroad.

In some cases, these improper corporate payments have involved staggering sums. One aircraft corporation, for example, disclosed secret payments of $22 million to foreign government officials to facilitate the sale of its military and civilian aircraft products in various parts of the world.[2] A major oil company has disclosed that approximately $5.4 million was generated surreptitiously for distribution to domestic political campaigns and candidates.[3] These and similar revelations have tarnished the image of many corporations, eroded public confidence in business and led former Securities and Exchange Commission Chairman Ray Garrett, Jr., to conclude that the illegal and improper conduct of American business

† The SEC, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are those of the authors and do not necessarily reflect the views of the Commission or its staff.

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1. Gwirtzman, *Is Bribery Defensible?*, N.Y. Times, Oct. 5, 1975, § 6 (Magazine), at 19.
2. *Lockheed Says it Will Resist SEC Efforts to Block it From Paying Bribes Abroad*, Wall St. Jour., Aug. 6, 1975, at 8, col. 1.
3. *Gulf Leads Toward a Cleanup*, TIME, Jan. 26, 1976, at 54.

represented "the second half of Watergate and by far the larger half."[4]

While bribes, kickbacks, and other forms of gratuitous payments have been a tradition in international trade for some time,[5] American participation in such practices remained largely unknown until recently.[6] With the discovery by the Watergate Special Prosecution Force that a number of corporations made illegal political contributions during the 1972 presidential campaign, however, the conduct of American business, both at home and abroad, has come under increasing scrutiny. The Congress,[7] the President,[8] and various federal agencies[9] have all initiated investigations or inquiries

4. *How Clean is Business?*, NEWSWEEK, Sept. 1, 1975, at 50. These disclosures of corporate abuse come at a time when the business community is already under attack for its lack of social and environmental responsibility. *See* Sonde and Pitt, *Utilizing the Federal Securities Laws to "Clear the Air! Clean the Sky! Wash the Wind!"* 16 How. L.J. 831, 833 (1971); Nader and Green, *What To Do About Corporate Corruption*, Wall St. Jour., March 12, 1976, at 18, col. 3.

5. *Payoffs: A Fact of Life in Asia*, Chicago Daily News, Feb. 24, 1976, at 5, col. 1; Sampson, *Lockheed's Foreign Policy: Who, In the End, Corrupted Whom?*, NEW YORK MAGAZINE, March 15, 1976, at 53.

6. Empirical studies of ethical behavior in international trade are almost nonexistent. *See* Robinson, *Ethical Standards of Foreign Business*, in ETHICS AND STANDARDS IN AMERICAN BUSINESS 220, 227 (J. Towle ed. 1964). *See also* Murphy, *Payoffs to Foreign Officials: Time For More National Responsibility*, 62 A.B.A.J. 480 (1976). One recent survey of American executives found at least half believed American corporations should be free to follow local customs, including paying bribes, if necessary, to secure business. *Payoffs: The Growing Scandal*, NEWSWEEK, Feb. 23, 1976, at 27. Some American corporations, however, refuse to pay bribes or irregular commissions. To the extent that a company's product or service is unique or highly differentiated, such payments are perhaps easier to resist. *See* Griffiths, *"Payoff" is Not "Accepted Practice,"* FORTUNE, Aug., 1975, at 122. *See generally* J. BASCHE, UNUSUAL FOREIGN PAYMENTS: A SURVEY OF THE POLICIES AND PRACTICES OF U.S. COMPANIES (1976).

7. Among others, the Senate Banking, Housing and Urban Affairs Committee, the House Commerce Subcommittee, and the Senate Subcommittee on Multinational Corporations have examined the problems presented by improper corporate payments. *See, e.g., Hearings on Political Contributions to Foreign Governments Before the Subcomm. on Multinational Corporations of Senate Comm. on Foreign Relation*, 94th Cong., 1st Sess. 12 (1975). See note 211 *infra* and accompanying text.

8. In April, 1976, President Ford established the Task Force on Questionable Payments Abroad. Under the direction of Commerce Secretary Elliot Richardson, the Task Force has been charged with conducting a comprehensive review of the problem of questionable foreign payments with a view toward recommending appropriate government action. *See* Simon, *U.S. Cracks Down on Foreign Payoffs, Illegal Acts*, TREASURY PAPERS, April, 1976, at 26.

9. These include the Federal Trade Commission and the Internal Revenue Service. *See Charge That General Tire Made Payoffs To Bar Competition Draws FTC Inquiry*, Wall St. Jour., Apr. 28, 1976, at 3, col. 2; Statement by Comm. of Internal Revenue, Donald C. Alexander, *Hearings Before the Subcomm. on International Economic Policy of the House Comm. on International Relations*, 94 Cong., 1st Sess. (1975) [hereinafter cited as *House Hearings*].

Section 162(c)(2) of the INT. REV. CODE OF 1954, provides, in part:

No deduction shall be allowed under Subsection (a) [relating to ordinary and

into questionable or illegal corporate payments.

Perhaps the most conspicuous of these investigations is that conducted by the Securities and Exchange Commission (the Commission). Since it began its enforcement program in the realm of questionable or illegal corporate payments in 1974, the Commission has brought civil injunctive actions against at least 20 public corporations, including a number of the nation's largest.[10] These actions

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> necessary business expenses] for any expenses paid or incurred if payment thereof is made, directly or indirectly, to any official or employee of a foreign country, and if the making of the payment would be unlawful under the laws of the United States, if such laws were applicable to such payment and to such official or employee.

There are two reported cases under section 162: United States v. Rexach, 331 F. Supp. (D.P.R. 1971), *vacated on other grounds*, 482 F.2d 10 (1st Cir.), *cert. denied*, 414 U.S. 1039 (1973); *In re* Al Farnsworth, 32 T.C.M. 903 (1973).

For a discussion of the impact of improper corporate payments under the Sherman Act, 15 U.S.C. § 1 *et seq.* (1970); *see* Statement by Deputy Asst. Atty. Gen., Donald I. Baker, *House Hearings*, *supra* note 9, *reprinted in* CCH FED. TRADE REP. ¶ 50,283 (1976). Commercial bribery may also trigger liability under the Robinson-Patman Act, 15 U.S.C. § 13(c) (1970). Rangen, Inc. v. Sterling Nelson & Sons, 351 F.2d 851, 858 (9th Cir.), *cert. denied*, 383 U.S. 936 (1965).

10. Securities and Exchange Commission v. Foremost-McKesson, Inc., Civil No. 76-1257 (D.D.C. filed July 7, 1976), SEC Lit. Rel. No. 7479 (July 7, 1976); Securities and Exchange Commission v. Chicago Milwaukee Corp., Civil No. 76-1024 (D.D.C. filed June 29, 1976), SEC Lit. Rel. No. 7472 (June 29, 1976); Securities and Exchange Commission v. Firestone Tire and Rubber Co., Civil No. 76-1064 (D.D.C. filed June 15, 1976), SEC Lit. Rel. No. 7443 (June 15, 1976); Securities and Exchange Commission v. Butler National Corp., Civil No. 76-0996 (D.D.C. filed June 9, 1976), SEC Lit. Rel. No. 7434 (June 9, 1976); Securities and Exchange Commission v. Emersons Ltd., (D.D.C. May 11, 1976), SEC Lit. Rel. No. 7392 (May 11, 1976); Securities and Exchange Commission v. General Tire and Rubber Co., (D.D.C. filed May 10, 1976), SEC Lit. Rel. No. 7386 (May 10, 1976); Securities and Exchange Commission v. Lockheed Aircraft Corp., Civil No. 76-0611 (D.D.C. filed April 13, 1976), SEC Lit. Rel. No. 7355 (April 13, 1976), CCH FED. SEC. L. REP. ¶ 95,905 (1976); Securities and Exchange Commission v. Waste Management, Inc., Civil No. 76-0496 (D.D.C. filed March 26, 1976), SEC Lit. Rel. No. 7333 (March 29, 1976), CCH FED. SEC. L. REP. ¶ 95,569 (1976); Securities and Exchange Commission v. Missouri Public Service Co., Civil No. 76-132-W-2 (W.D. Mo. filed Feb. 27, 1976), SEC Lit. Rel. No. 7299 (March 4, 1976); Securities and Exchange Commission v. Braniff Airways, Inc., Civil No. 76-0485 (D.D.C. filed March 24, 1976), SEC Lit. Rel. No. 7327 (March 24, 1976); Securities and Exchange Commission v. General Refractories Co., Civil No. 75-0809 (D.D.C. filed May 21, 1975), SEC Lit. Rel. No. 6898 (May 21, 1975), SEC Lit. Rel. No. 6128 (June 11, 1975), SEC Lit. Rel. No. 7098 (Sept. 24, 1975); Securities and Exchange Commission v. Ashland Oil, Inc., Civil No. 75-0794 (D.D.C. filed May 16, 1975), SEC Lit. Rel. No. 6890 (May 19, 1975); Securities and Exchange Commission v. Northrop Corp., Civil No. 75-0563 (D.D.C. filed April 16, 1975), SEC Lit. Rel. No. 6839 (April 16, 1975); Securities and Exchange Commission v. Sanitas Service Corp., Civil No. 75-0520 (D.D.C. filed April 10, 1975), SEC Lit. Rel. No. 6829 (April 11, 1975), SEC Lit. Rel. No. 6952 (June 30, 1975); Securities and Exchange Commission v. United Brands Co., Civil No. 75-0509 (D.D.C. filed April 9, 1975), SEC Lit. Rel. No. 6827 (April 10, 1975), SEC Lit. Rel. No. 7251 (Jan. 27, 1976); Securities and Exchange Commission v. Gulf Oil Corp., Civil No. 75-0382 (D.D.C. filed March 11, 1975), SEC Lit. Rel. No. 6780 (March 11, 1975); Securities and Exchange Commission v. Phillips Petroleum Co., Civil No. 75-0308 (D.D.C. filed March 31, 1975), SEC Lit. Rel. No. 6770 (March 31, 1975); Securities and Exchange Commission v. Minnesota Mining and Manufacturing Co., Civil No. 3-7529 (W.D.

were based on the failure to disclose questionable or illegal corporate payments to public investors. At present, the staff of the Commission is also conducting formal investigations into the activities of a number of other public corporations to determine the existence of similar violations.[11] In addition to Commission action, at least 100 corporations have voluntarily reported improper payments to the Commission, and that number will undoubtedly increase in the future.[12]

Despite the Commission's present role in the discovery of corporate misconduct, its interest in the ethical or illegal practices of American corporations is only indirect. The basic orientation of the federal securities laws is decidedly conservative: the protection of the investing public rests upon a policy of "full and fair disclosure"[13] of all relevant information to all investors.[14] The Commission, as such, has no general authority to proscribe any forms of substantive corporate conduct or behavior.[15]

The Commission does, however, have broad authority to determine what matters, in addition to those specifically enumerated in

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Minn. filed January 31, 1975), SEC Lit. Rel. No. 6711 (January 31, 1975); Securities and Exchange Commission v. Kalvex, Inc., (S.D.N.Y. filed December 23, 1974), SEC Lit. Rel. No. 6654 (December 27, 1974), CCH FED. SEC. L. REP. ¶ 95,226 (1975); Securities and Exchange Commission v. American Ship Building Co., Civil No. 75-0588 (D.D.C. filed April 15, 1974), SEC Lit. Rel. No. 6319 (April 15, 1974).

11. *SEC May Uncover More Domestic Bribes Using Foreign Payoff Detection Methods*, Wall St. Jour., Mar. 10, 1976, at 2, col. 2.

12. Guzzardi, *An Unscandalized View of Those Bribes Abroad*, FORTUNE, July, 1976, at 118.

13. Preamble, Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (1970).

14. *See* 40 SEC ANN. REP. 25; 1 L. LOSS, SECURITIES REGULATION 21 (2d ed. 1961) [hereinafter cited as Loss]. Disclosure provisions are common to each of the separate acts constituting the federal securities laws. Securities Act of 1933, §§ 5, 7, 10, 15 U.S.C. §§ 77e, 77g, 77j (1970); Trust Indenture Act of 1939, § 313, 15 U.S.C. § 77mmm (1970); Securities Exchange Act of 1934, §§ 12, 13, 15 U.S.C. §§ 78*l*, 78m (1970); Public Utility Holding Company Act of 1933, §§ 4, 5, 15 U.S.C. §§ 79d, 79e (1970); Investment Company Act of 1940, § 8, 15 U.S.C. § 80a-8 (1970); Investment Advisers Act of 1940, §§ 203, 204, 15 U.S.C. §§ 80b-3, 80b-4 (1970).

The basic elements of the disclosure process, however, are found in the Securities Acts of 1933 and the Securities Exchange Act of 1934. The Commission's responsibilities under these acts have been described as "first, to preside over the process of disclosure, especially by issuers of securities, upon which these laws so basically rely; and second, to regulate substantive conduct in the securities market, both directly and by the supervision of industry self-regulation." REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 4, at 719 (1963).

15. Sommer, *The Disclosure of Management Fraud*, 31 BUS. LAW. 1283 (1976); In the Matter of Universal Camera Corp., 19 S.E.C. 648 (1945). The idea of federal incorporation has never been accepted by Congress. Loss, *supra* note 14, at 107-11. *But cf.* Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); Bahlman, *Rule 10b-5: The Case For Its Full Acceptance As Federal Corporation Law*, 37 CIN. L. REV. 727 (1968); Nader, Green and Seligman, *Constitutionalizing The Corporation*, BNA SEC. REG. & L. REP., No. 337, F-1 (1976).

the various Acts it administers, are necessary and appropriate for disclosure to investors. In this regard, section 19(a) of the Securities Act of 1933 (Securities Act)[16] authorizes the Commission to promulgate such rules "as may be necessary to carry out the provisions of this title. . . ." Section 23(a) of the Securities Exchange Act of 1934 (Exchange Act) incorporates a similar grant of authority.[17] In addition, specific sections of these Acts confer independent grants of rule-making authority upon the Commission, allowing it to specify additional information in the various filings required under these Acts.[18]

The Commission has not yet formally exercised such authority to specify or articulate the conditions under which questionable or illegal corporate payments must be disclosed. Under pressure from issuers, accountants, and others involved in the disclosure process, the Commission has considered the adoption of formal guidelines on the disclosure requirements of questionable or illegal foreign payments.[19]

The problems encountered in drafting such guidelines, however, are formidable, involving competing considerations of investor protection, international trade, and foreign policy. The disclosure of improper payments, as such, may be dysfunctional in jeopardizing substantial foreign investments and reducing the competitive position of American firms, without a corresponding benefit to investors.[20] Disclosure may also render the conduct of U.S. foreign policy more difficult, embarrass U.S. allies, and increase the burdens faced by all American businesses operating abroad.[21]

In view of these difficulties, it is not surprising that specific guidelines have not been issued by the Commission. Instead, the Commission has elected to issue a report which summarizes its actions on the disclosure of questionable or illegal payments.[22] Although providing some disclosure guidance to the corporate community, the Commission deliberately omitted any "litmus paper test."[23]

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16. 15 U.S.C. § 77s (1970).

17. 15 U.S.C. § 78w (1970).

18. See notes 113 through 116 *infra* and accompanying text.

19. *SEC's Fuzziness on What Illicit Dealings Should Be Reported Limits Disclosures*, Wall St. Jour., Mar. 29, 1976, at 26, col. 1.

20. *Payoff Scandals Give Edge to Foreign Firms*, Wall St. Jour., Mar. 18, 1976, at 1, col. 6.

21. While the State Department has refused to condone the actions of U.S. firms making illegal payments abroad, Secretary Kissinger recently noted the premature disclosure of such payments may damage U.S. foreign relations. Wall St. Jour., Dec. 15, 1975, at 2, col. 3.

22. SEC REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, BNA SEC. REG. & L. Rep., No. 353 (1976) [hereinafter cited as SEC REPORT].

23. *Id.* at 6.

Thus, the Commission's enforcement program remains the most specific expression of the minimum disclosure requirements acceptable to it.

This article, then, will trace the evolution of the Commission's enforcement program, analyze the legal standards upon which it proceeded and suggest the Commission's future posture.

ORIGINS OF THE COMMISSION'S ENFORCEMENT PROGRAM

The Commission's interest in improper corporate payments derives generally from the investigations conducted by the staff of the Watergate Special Prosecution Force into campaign contributions by corporations during the 1972 presidential campaign.[24] By October, 1975, the Watergate Special Prosecution Force had obtained convictions against 16 corporations[25] for violations of the Corrupt Practices Act,[26] which generally proscribes campaign contributions by corporations in federal elections. A number of these corporations had voluntarily disclosed campaign contributions after Special Prosecutor Archibald Cox announced an amnesty program in July, 1973.[27] Others came forward after discovering or concluding that their activities were under investigation. In some cases, corporate officers responsible for the contributions were also charged.[28]

In the course of its inquiry into the source of funds used to make corporate contributions, the Watergate Special Prosecution Force learned that many contributions came from accumulations of corporate cash in political "slush funds," generated by fictitious or unre-

24. *Homily On The Glories of Right Conduct and The Wages of Sin*, Address by Ray Garrett, Jr., in White Sulphur Springs, W. Va., June 27, 1975, at 9-10 [hereinafter cited as Garrett, *Homily*]. The Watergate Special Prosecution Force was established on May 25, 1973, as an independent investigation and prosecution force within the Department of Justice. Its primary jurisdiction included all offenses connected with the unauthorized entry into the Democratic National Committee headquarters at the Watergate as well as all offenses rising out of the 1972 presidential election. WATERGATE SPECIAL PROSECUTION FORCE REPORT 5-6 (1975). *See also* FINAL REPORT OF THE SELECT COMMITTEE ON PRESIDENTIAL CAMPAIGN ACTIVITIES OF THE UNITED STATES SENATE, S. REP. No. 93-981, 93d Cong., 2d Sess. 445-577 (1974) [hereinafter cited as SENATE SELECT COMMITTEE REPORT].

25. WATERGATE SPECIAL PROSECUTION FORCE REPORT 158-59 (1975).

26. 18 U.S.C. § 610 (1970), *as amended* 18 U.S.C. § 610 (Supp. IV, 1974). Section 610 was originally enacted to reduce the influence exercised by corporations through financial contributions and to restrict corporate officials from using corporate funds for contributions to political parties without the consent of the shareholders. Cort v. Ash, 422 U.S. 66 (1975); United States v. UAW, 352 U.S. 567, 570-75 (1957); United States v. CIO, 335 U.S. 106, 113, 134-35 (1948). *See generally* Note, *Regulation of Campaign Funding and Spending for Federal Office*, 5 U. MICH. J.L. REFORM 159, 163 (1972); Lobel, *Federal Control of Campaign Contributions*, 51 MINN. L. REV. 1, 39 (1966). For a history of section 610 *see* E. EPSTEIN, CORPORATIONS, CONTRIBUTIONS, AND POLITICAL CAMPAIGNS: FEDERAL REGULATION IN PERSPECTIVE (1968).

27. WATERGATE SPECIAL PROSECUTION FORCE REPORT 72 (1975).

28. *Id.* at 73-78.

corded transactions in overseas subsidiaries. Ashland Oil Company, for example, was convicted of making a $100,000 cash contribution to the Finance Committee to Re-Elect the President in 1972. The corporate funds from which this contribution was made had originally been disbursed by a foreign subsidiary, Ashland Petroleum Gabon Corp., of Gabon, Africa, and charged off to an undeveloped leasehold.[29] The money was then deposited in a Swiss bank and later delivered directly to Maurice Stans, treasurer of the Finance Committee, by an Ashland vice president.[30]

In other cases, the Watergate Special Prosecution Force discovered that campaign funds were generated through fictitious advances or expenses; through volume discounts from suppliers; or through "voluntary" contributions by corporate employees subsequently reimbursed from corporate funds.[31] Special commission payments to third party agents were also used to raise cash for political contributions.[32] In all of these cases, the contributions, and the bookkeeping practices which made them possible, were not disclosed to shareholders and others in the periodic and other filings made by these corporations under the Securities Act and the Exchange Act.

In the belief that such misuses of corporate assets were of interest to investors, the Commission took its first public action on March 8, 1974, issuing a release containing the views of the Commission's Division of Corporation Finance on the disclosure requirements applicable to illegal campaign contributions by public corporations.[33] According to the release, "the conviction of a corporation and/or its officers or directors for having made illegal campaign contributions in violations of 18 U.S.C. Section 610 is a material fact that should be disclosed to the public and specifically to shareholders. . . ."[34] The Division declined to express an opinion on the disclosure of corporate contributions which, though perhaps illegal, had not yet become the subject of formal proceedings. In those cases, the necessity of disclosure was left to the discretion of the corporation's own management.

The staff of the Commission also requested and received access to the information developed by the Watergate Special Prosecution Force and began its own investigations. Unlike that of the Water-

29. SENATE SELECT COMMITTEE REPORT, *supra* note 24, at 459.
30. *Id.*
31. *Id.* at 447.
32. *Id.* at 448.
33. SEC Securities Act Rel. No. 5466 (Mar. 8, 1974).
34. *Id.*

gate Special Prosecution Force, however, the scope of the Commission's inquiry was not limited to matters relating to a particular campaign or event. As a result, the staff discovered that unrecorded corporate "slush funds" had been in existence for some time; that senior management was often instrumental in the creation of these funds; and that monies from such funds had been disbursed not only for domestic political campaigns, but also for foreign political campaigns and other questionable purposes. The existence of these funds, the staff found, was possible only through the deliberate falsification of the corporations' financial records and statements, and the intentional deception of outside directors and independent auditors.[35]

In many cases, moreover, the system of financial accountability had been systematically subverted and abridged to conceal the true source and application of large sums of corporate money. Since the integrity and accuracy of financial records are basic to the disclosure process,[36] these unrecorded funds were of special concern to the Commission and its staff. As the dimensions of these practices became more evident, a special enforcement program, called the "Management Fraud Program," was established to coordinate investigations and enforcement proceedings.[37]

COMMISSION ENFORCEMENT ACTIONS

Upon consideration of the staff's investigative findings, the Commission determined injunctive actions were necessary in a number of cases.[38] Of these, some involved only allegations of improper domestic payments,[39] others involved only allegations of improper foreign payments,[40] and the rest included allegations of both types.[41]

35. Doherty, *The SEC's Management Fraud Program*, 31 BUS. LAW. 1279 (1976) [hereinafter cited as Doherty].

36. *See* Herzfeld v. Laventhal, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 122 (S.D.N.Y. 1974), *aff'd in part*, CCH FED. SEC. L. REP. ¶ 95,660 (2d Cir. 1976); Securities and Exchange Commission v. Kalvex, Inc., CCH FED. SEC. L. REP. ¶ 95,226 (S.D.N.Y. 1975).

37. Doherty, *supra* note 35.

38. See note 10 *supra*.

39. *See, e.g.*, Securities and Exchange Commission v. Minnesota Mining & Manufacturing, Civil No. 3-7529. (W.D. Minn. filed Jan. 31, 1975), SEC Lit. Rel. No. 6711 (Jan. 31, 1975); Securities and Exchange Commission v. Missouri Public Service Company, Civil No. 76-132-W-2 (W.D. Mo. filed Feb. 27, 1976), SEC Lit. Rel. No. 7299 (Mar. 4, 1976).

40. *See, e.g.*, Securities and Exchange Commission v. United Brands, Civil No. 75-0509 (D.D.C., filed Apr. 9, 1975), SEC Lit. Rel. No. 6827 (Apr. 10, 1975), SEC Lit. Rel. No. 7251 (Jan. 27, 1976); Securities and Exchange Commission v. Lockheed Aircraft Corp., Civil No. 76-0611, (D.D.C. filed Apr. 13, 1976), SEC Lit. Rel. No. 7355 (Apr. 13, 1976).

41. *See, e.g.*, Securities and Exchange Commission v. Ashland Oil, Inc., Civil No. 75-0794 (D.D.C. filed May 19, 1975), SEC Lit. Rel. No. 6890 (May 19, 1975); Securities and Exchange Commission v. Northrop Corporation, Civil No. 75-0563 (D.D.C. filed Apr. 16, 1975), SEC Lit. Rel. No. 6839 (Apr. 16, 1975).

In determining to pursue specific cases, the Commission adopted an ad hoc or transactional approach: a determination to bring injunctive action was made only after a consideration of the specific facts of each case. Exercising its prosecutorial discretion,[42] the Commission elected not to pursue a dragnet. The variety of facts, the novelty of the issues, and the pace of developments all discouraged the adoption of such a categorical approach.[43] Instead, the Commission proceeded, at least initially, only against what it perceived to be egregious examples.

Illegal Domestic Payments

The Commission's first action was against American Ship Building Company and its chief executive officer, George M. Steinbrenner, III. On August 23, 1974, American Ship Building Company entered a plea of guilty to a one-count indictment alleging a violation of the Corrupt Practices Act.[44] This plea stemmed from a single $100,000 contribution to the Committee to Re-Elect the President by Ronald H. Slater, an American Ship Building Company official, on April 6, 1972.[45] Part of this contribution was later traced to corporate funds, which had been disbursed to senior company officials as purported "bonuses" and later made available to the company.[46] Steinbrenner was the only corporate officer authorized to grant such bonuses.[47]

Earlier, on April 15, 1974, the Commission filed suit against American Ship Building Company and Steinbrenner.[48] The complaint alleged that as a result of unrecorded political contributions since 1970, the company, aided and abetted by Steinbrenner, had violated sections 13 and 14 of the Exchange Act by failing to disclose the contributions in the periodic and proxy solicitation filings required under those sections and the rules adopted thereunder.[49]

42. Securities and Exchange Commission v. Chenery Corp., 332 U.S. 194, 202, 203 (1947).

43. The IRS, by contrast, has begun a systematic examination of the 1,000 largest U.S. corporations. Wall St. Jour., Mar. 3, 1976, at 1, col. 6.

44. WATERGATE SPECIAL PROSECUTION FORCE REPORT 76 (1975). At the same time, Steinbrenner entered a plea of guilty to a conspiracy charge and to a charge of being an accessory after the fact to a corporate contribution. He was fined $15,000 while American Ship Building Company received a $20,000 fine.

45. SENATE SELECT COMMITTEE REPORT, *supra* note 24, at 453.

46. On April 6, 1972, American Ship Building Company paid nine employees bonuses totaling $42,325.17. On the same day, they each wrote personal checks totaling $25,000 (representing approximately the net amount of the bonuses after deductions for taxes). These checks were then given to various committees supporting the re-election of President Nixon on April 6. American Ship Building Corp., Form 8-K (May 1975), SEC File No. 1-455, at 37.

47. SENATE SELECT COMMITTEE REPORT, *supra* note 24, at 453.

48. SEC Lit. Rel. No. 6319 (Apr. 15, 1974).

49. Section 13, 15 U.S.C. § 78m (1970) and the rules adopted thereunder generally provide

Implicit in the allegations of the Commission's complaint was the notion that the making of these contributions, and the falsification of the company's records to conceal them, were material events in themselves, regardless of the legal consequences which followed.

In addition to requesting a permanent injunction against future violations of these sections, as authorized by statute,[50] the Commission also requested certain ancillary relief, based on the inherent powers of the court to fashion appropriate relief in equitable proceedings.[51] The principal form of ancillary relief sought was the appointment of a special master to inquire into and examine the corporation's books and records for evidence of illegal or unrecorded contributions and to render an accounting to the court and to the shareholders.[52]

On October 4, 1974, the company and Steinbrenner entered into a consent decree with the Commission. Without admitting or denying the allegations in the complaint, both consented to the entry of permanent injunctions.[53] The company was thus enjoined from:

> (1) filing or causing to be filed false or misleading annual, periodic or other statements required by section 13;
> (2) soliciting proxy statements without disclosing, *inter alia*, that corporate funds were used to make illegal political contributions; and
> (3) making or causing to be made false or fictitious entries on the company's books and records.[54]

At the same time, the company was ordered to establish a special review committee. Composed of three independent, outside board members, the committee was charged with examining the company's records to determine whether since 1970 corporate funds were

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that issuers of securities registered under the Exchange Act make certain annual, periodic and other filings as necessary to keep current the information contained in the registration application or statement. *See* Exchange Act rules 13a-1, 17 C.F.R. § 240.13a-1 (1976); 13a-11, 17 C.F.R. § 240.13a-11 (1976); 13a-13, 17 C.F.R. § 240.13a-13 (1976). Section 14, 15 U.S.C. § 78n (1970) and rule 14a-9, 17 C.F.R. § 240.14a-9 (1976), provide in part that in exercising his franchise, the shareholder must be informed of all material facts.

50. 15 U.S.C. §§ 78u(d), 78u(e) (Supp. V, 1975).

51. *See, e.g.*, Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1105-06 (2d Cir. 1972); Securities and Exchange Commission v. R. J. Allen and Associates, Inc., 386 F. Supp. 866 (S.D. Fla. 1974); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307 (2d Cir. 1971). *See generally* 3 Loss, *supra* note 14, at 1975-84; Yaeger and Yadley, *Equitable Uncertainties in SEC Injunctive Actions*, 24 EMORY L.J. 639 (1975); Pitt and Markham, *SEC Injunctive Actions*, 6 REV. SEC. REG. 955 (1973); Mathews, *SEC Civil Injunctive Actions I & II*, 5 REV. SEC. REG. 949, 956, 969-76 (1972).

52. See note 48 *supra*.

53. SEC Lit. Rel. No. 6534 (Oct. 4, 1974).

54. *Id.*

used for purposes other than those recorded on the corporation's books.[55]

The company further agreed to prepare and file the committee's report with the Commission as an exhibit to a current Form 8-K.[56] The court's order also provided that the report was to be reviewed by the company's board, which would implement any findings or recommendations contained in the report, although the Commission retained the right to seek additional ancillary relief if it found the actions of the board unsatisfactory.[57] For his part, Steinbrenner agreed to reimburse the company for any funds expended for political or any other unauthorized purposes if the board determined such reimbursement was necessary. Again, the Commission was free to seek additional relief against him if it believed such was necessary.[58]

On May 1, 1975, the special committee filed its final report with the court and the Commission. After reviewing the origin of the corporate campaign program and Steinbrenner's role therein, the report provided an accounting of corporate funds used for political contributions. This accounting disclosed, to the extent possible, the identity of the recipients of corporate contributions. It also disclosed that the company's outside auditor, Arthur Andersen & Co., was aware of the bonus program as early as 1971 and suspected that these expenditures were not a proper use of corporate funds.[59]

The complaint and consent in *Securities and Exchange Commission v. American Ship Building Company*[60] set the pattern for later Commission actions. Despite the allegation that the defendants failed to disclose material information, the Commission did not allege violations of the general anti-fraud provisions of the federal securities laws—section 17(a) of the Securities Act and section 10(b) of the Exchange Act.[61] The Commission apparently

55. *Id.*
56. *Id.*
57. *Id.*
58. *Id.*
59. American Ship Building Co., SEC Form 8-K (May, 1975), SEC File No. 1-455, at 32-41. In tracing corporate funds, the committee was forced to rely upon the recollection of employees receiving bonuses. As a result, the committee was unable to determine the exact disposition of all corporate funds. *Id.* at 32.
60. Civil No. 75-0588 (D.D.C. filed April 15, 1974), SEC Lit. Rel. No. 6319 (April 15, 1974).
61. 15 U.S.C. §§ 77q, 78j (1970). Under the authority of § 10(b) of the Exchange Act, the Commission promulgated rule 10b-5, 17 C.F.R. § 240.10b-5 (1976). It provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.
>
> (a) To employ any device, scheme, or artifice to defraud,

elected to take a less drastic approach, casting the issue as a false filing case, not as a fraud case. This posture may be a reflection of the Commission's visceral uncertainty about the "materiality" of these undisclosed contributions, particularly in view of its release of March 8, 1974, or it may be symptomatic of a disinclination to "bootstrap" a rule 10b-5 fraud charge solely on the basis of an omission in the registrant's filings.[62]

As in other cases of management misconduct,[63] the Commission accepted ancillary relief based on the use of a committee of outside directors. Although this form of "exotic" ancillary relief has been criticized as unauthorized, unnecessary, and an unjustified intrusion on the rights of shareholders and state corporation law,[64] it does have distinct advantages. Empowering a committee of the board to conduct its own inquiry and to provide an accounting saves limited Commission manpower and resources. It also allows the Commission to file the case without a full investigation but while the equity or necessity for an injunction is still obvious.[65] And, since the committee can exercise economic leverage over otherwise reluctant employees, the problems of proof are reduced, particularly where the identity of recipients of corporate funds is at issue. Similarly, such a committee, representing the company, may be able to circumvent

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(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

62. *See, e.g.*, Hayden v. Walston & Co., Inc., 528 F.2d 901 (9th Cir. 1975).

63. Securities and Exchange Commission v. Mattel, Inc., (D.D.C. filed Oct. 2, 1974), SEC Lit. Rel. Nos. 6531 (Oct. 3, 1974), 6532 (Oct. 4, 1974); Securities and Exchange Commission v. Canadian Javelin, Ltd., (S.D.N.Y. filed July 17, 1974); SEC Lit. Rel. No. 6441 (July 18, 1974); Securities and Exchange Commission v. Coastal States Gas Corp., (S.D. Tex. 1973), SEC Lit. Rel. No. 6054 (Sept. 1, 1973). *See generally* Treadway, *SEC Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 WASH. & LEE L. REV. 637 (1975); Mathews, *Liabilities of Lawyers Under the Federal Securities Laws*, 30 BUS. LAW. 105, 144-45 (1975); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. PA. L. REV. 1188 (1975); Comment, *Injunctive Relief in SEC Civil Actions: The Scope of Judicial Discretion*, 10 COLUM. J.L. & SOC. PROB. 328 (1974).

64. Malley, *Far-Reaching Equitable Remedies Under the Securities Acts and the Growth of Federal Corporate Law*, 17 WM. & MARY L. REV. 47 (1975); Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, 64-65 (1975). Mathews, *SEC Enforcement in 1974: Despite Criticism, A Vigorous Expanding Program Proceeds*, in A. MATHEWS, ENFORCEMENT AND LITIGATION UNDER THE FEDERAL SECURITIES LAWS— 1975, at 551 (1975).

65. *Cf.* Securities and Exchange Commission v. Koracorp Industries, Inc., CCH FED. SEC. L. REP. ¶ 95,532 (N.D. Cal. 1976), where the court found the lack of any violations in the previous 18 months one reason to dismiss an SEC complaint for injunctive relief.

any attorney-client privilege, thus gaining access to relevant information often already in the hands of the company's outside counsel.

Questionable and Illegal Domestic and Foreign Payments

Another variation of questionable or illegal corporate activity which came to the Commission's attention involved both domestic and foreign payments by Gulf Oil Corporation (Gulf). The defendants, including Gulf and a former company vice-president, Claude C. Wild, Jr.,[66] were charged with creating a secret fund for unlawful political contributions and disbursements overseas for improper purposes.

As in earlier cases, the Commission's action in this matter stemmed from the Watergate Special Prosecution Force's investigation into political contributions. During the course of this investigation, a separate action was brought by Common Cause against the Finance Committee to Re-Elect the President (the Finance Committee) for illegal political contributions received during former President Nixon's 1972 campaign for re-election.[67]

As a result of the consent decree obtained by Common Cause, the Finance Committee was required to disclose its receipts and disbursements for the period from January 1, 1971 through April 6, 1972.[68] Pursuant to this requirement, the Finance Committee, in July of 1973, solicited Wild to confirm cash contributions made by him purportedly on behalf of the "Employees of Gulf Oil Company" in the total amount of $100,000.[69]

Shortly thereafter, Wild informed Robert Dorsey, at the time chairman and chief executive officer, of the inquiry and advised him that the $100,000 contribution did not represent employee funds, but rather, Gulf's corporate funds.[70] These revelations were brought to the attention of Gulf's board of directors, and on August 10, 1973, Gulf issued a press release disclosing the contribution of $100,000.[71]

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66. Securities and Exchange Commission v. Gulf Oil Corp., Civil No. 75-0324 (D.D.C. filed March 11, 1975), SEC Lit. Rel. No. 6780 (March 11, 1975).

67. *See* REPORT OF THE SPECIAL REVIEW COMMITTEE OF THE BOARD OF DIRECTORS OF GULF OIL CORPORATION, John J. McCloy, Chairman, 7 (December 30, 1975) [hereinafter cited as McCLOY REPORT].

The McCLOY REPORT was prepared by a Committee comprised of John J. McCloy, Chairman, a partner in the New York law firm of Milbank, Tweed, Hadley & McCloy; Nathan W. Pearson, a financial advisor and director of Gulf since 1969; and Beverley Matthews, Q.C., a partner in the Toronto law firm of McCarthy and McCarthy and a director of Gulf since 1958. The Committee was assisted in its endeavors by an independent accounting firm, S. D. Leisedorf & Co.

68. *Id.* at 7.

69. *Id.* at 8.

70. *Id.*

71. *Id.* at 10.

As a result of the aforementioned activities, on November 13, 1973, both Gulf and Wild were charged in an information with a one-count violation of the Corrupt Practices Act. On the same day, Gulf and Wild entered guilty pleas and were fined $5,000 and $1,000, respectively.[72]

The activity of the Watergate Special Prosecution Force led to the filing of a shareholder derivative suit against Gulf and Wild on March 27, 1974. This suit, brought by the Project on Corporate Responsibility, sought to recover the unlawful political contributions made by Gulf and all related costs and expenses. On the basis of a compromise stipulation, wherein, among other things, Wild made payment to Gulf of $25,000, the suit was dismissed with prejudice on June 27, 1974.[73]

Subsequently, the Commission began its own investigation into Gulf's illicit activities. This investigation ultimately culminated in the Commission filing a civil injunctive suit against Gulf and Wild on March 11, 1975. On the same day, Gulf consented to the entry of a final judgment of permanent injunction and entered into an Undertaking.[74]

The Commission's complaint maintained that from 1960 until March, 1975, the defendants had disbursed in excess of $10 million of Gulf corporate funds to a wholly-owned subsidiary, the Bahamas Exploration Company, Ltd. (Bahamas X), and other Gulf subsidiaries by means of false entries on its books and records. It was further alleged that at least $5.4 million of these funds was returned to the United States for the purposes of making illegal political contributions, with the balance being distributed overseas for "improper or unlawful purposes."[75]

The complaint charged that during the specified period, the defendants had filed, or caused to be filed, with the Commission certain reports, including annual reports as required by section 13(a) of the Exchange Act and rule 13a-1 thereunder.[76] It further alleged that such reports were violative of rule 12b-20,[77] insofar as they

72. *Id.* at 11-12.

73. *Id.* at 16-17.

74. SEC Lit. Rel. No. 6780 (March 11, 1975). See note 81 *infra* and accompanying text.

75. SEC Complaint ¶ 11, Securities and Exchange Commission v. Gulf Oil Corp., Civil No. 75-0324 (D.D.C. filed March 11, 1975).

76. 15 U.S.C. § 78m(a) and 17 C.F.R. § 240.13a-1, which require a reporting corporation to file, among other things, a Form 10-K annual report with the Commission.

77. 17 C.F.R. § 240.12b-20, which states:

> In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.

failed to disclose, among other things, the following material information: that the defendants "maintained a secret fund of corporate monies, which were used for unlawful political contributions and other purposes"; that monies from this fund were disbursed through a Gulf subsidiary "by means of false entries in the books and records of Gulf"; and that Gulf had filed financial statements with the Commission "which did not accurately present the accounts of the company, in that they falsely described the expense and net income of Gulf and understated the assets of Gulf."[78]

The second count of the complaint charged that during the specified period the defendants had filed with the Commission proxy statements for annual meetings, in violation of section 14(a) of the Exchange Act and rule 14a-9 thereunder.[79] This count incorporated the lack of disclosures set forth above.

The Commission requested that the defendants be permanently enjoined from violating the above discussed sections of the federal securities laws, and from making illegal political contributions. In addition, certain ancillary relief was requested. This included the requirement that Gulf correct and amend the previously misstated reports; that a special master be appointed to inquire into the alleged irregularities; and that an order be entered requiring Gulf and Wild to account for funds expended for unlawful political contributions or other unlawful purposes. An order was also sought against Wild seeking reimbursement to Gulf for funds so expended.

On March 11, 1975, the Honorable John S. Sirica, of the United States District Court for the District of Columbia, entered a Final Judgment of Permanent Injunction, by consent, against Gulf.[80] This order enjoined Gulf from violating sections 13(a) and 14(a) of the Exchange Act and rules 12b-20, 13a-1, and 14a-9 in connection with the filing of materially false and misleading annual or other periodic reports, as well as proxy statements, and from making or causing to be made materially false or fictitious entries in Gulf's corporate records.

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78. SEC Complaint ¶¶ 10-12, Securities and Exchange Commission v. Gulf Oil Corp., Civil No. 75-0324 (D.D.C. filed March 11, 1975). *See also* SEC Lit. Rel. No. 6780 (March 25, 1975).

79. 15 U.S.C. § 78n(a) (1970) and 17 C.F.R. § 240.14a-9 (1976), which provides, in part, that proxy solicitations must not contain false or misleading information concerning material facts, or omit to state material facts. It should be noted that the Commission did not charge a violation of rule 14a-3, 17 C.F.R. § 240.14a-3 (1976), which specifies the items of information which must be contained in written proxy statements furnished security holders. Also not charged was the general anti-fraud provision of the Exchange Act, section 10(b), 15 U.S.C. § 78j(b) (1970) and rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1976).

80. See note 66 *supra*.

Incorporated within the March 11 order was an Undertaking[81] by Gulf to accomplish certain tasks within specified time periods. The Undertaking included the representation that prior to the institution of the Commission's action, Gulf's board of directors had implemented stricter controls to assure compliance with Gulf's policy against the use of corporate funds for unlawful political contributions. It also stated that Gulf's board had established a Special Review Committee (the Committee), consisting of a chairman who was not affiliated with Gulf and two independent members of the board. The Committee was to fully investigate the use of corporate funds for illegal or improper purposes and to submit a report of its investigation to Gulf's board. Such report was to be filed with the Commission as an exhibit to a Form 8-K and was to be made part of the record in the district court proceedings.

Pursuant to Gulf's Undertaking, on December 30, 1975, a report was submitted by the Committee.[82] The report was filed simultaneously with the district court and with the Commission. It provided a detailed analysis of the irregular activity engaged in by Gulf, both on the domestic and international scenes, dating as far back as 1959.

A. Gulf's Domestic Political Contributions

In viewing Gulf's domestic political activity, the Committee concluded that such activity "was shot through with illegality."[83] Believing that Gulf needed more political muscle,[84] William Whiteford, Gulf's then chairman and chief operating executive, formed the first unrecorded political fund as early as 1959. Whiteford intended that this fund be utilized to make political contributions or other types of payments to further Gulf's interests.[85]

The conduit through which such payments initially flowed, Bahamas X, was organized in 1944 in anticipation of exploring for oil in the Bahamas. Such exploration never materialized and from 1944 until 1960, Bahamas X was merely a holding company for various exploration licenses.[86] Between 1960 and 1961, approximately $350,000 was transferred from Gulf's Pittsburg headquarters directly to a Bahamas X bank account which had been opened with

81. An Undertaking is filed with the court and may be the basis for a contempt proceeding if future violations occur. Securities and Exchange Commission v. Martin Frank, SEC Lit. Rel. No. 3957 (S.D.N.Y. 1968); Securities and Exchange Commission v. First National City Bank, SEC Lit. Rel. No. 4534 (S.D.N.Y. 1970).

82. McCloy Report, *supra* note 67, at 7.

83. *Id.* at 31.

84. *Id.* at 32.

85. *Id.* at 32-33.

86. *Id.* at 37.

the Bank of Nova Scotia in Nassau. The transfers from Gulf to Bahamas X were recorded as deferred charges, and not shown on Gulf's books as cash transfers. Also not reflected on Gulf's books was the existence of this company's bank account in which funds so transferred were deposited and from which they were periodically withdrawn.[87] Thus, funds which reached this bank account were totally removed from normal corporate controls and were concealed through fictitious accounting entries.

A second bank account was opened with the Bank of Nova Scotia in August of 1961. This account received an initial deposit from Gulf corporate funds of $200,000. Again, no record of either deposits or withdrawals was ever entered on the books of Bahamas X. From 1960 until 1972, when Bahamas X was liquidated, a total of $5,186,000 in Gulf funds was transferred to the Bahamas X accounts with the Bank of Nova Scotia.[88] None of these funds was adequately accounted for nor were disbursements documented.

Between 1960 and 1972, Wild, as Gulf's top lobbyist, distributed approximately $4.1 million of this fund to scores of politicians. The money was funneled to Wild from the Bahamas X in cash packets of $25,000 each at Gulf offices around the country. Wild distributed the money at the rate of $300,000 to $400,000 per year, dividing it about equally between candidates for federal office and those for state and local offices.[89]

B. Gulf's Foreign Payments

In addition to the corporate funds expended domestically, Gulf disbursed approximately $4 million to various influential figures in Italy, Sweden, Canada and Turkey. In Bolivia, Gulf was the reluctant suitor of the favors of General Rene Barrientos, who later became dictator of Bolivia. Gulf purchased on his behalf a $107,925 helicopter.[90]

In Korea, Gulf's disbursements were of a grander scale. Between 1966 and 1971, Dorsey ordered payments totaling over $4 million to politicians in South Korea, where Gulf had sizeable operations. In one case, an influential South Korean politician demanded a $10 million political contribution to his party in order for Gulf to enjoy

87. *Id.* at 40.

88. *Id.* at 51-55.

89. A partial list of the recipients of such funds include the campaigns of Senator Henry Jackson ($10,000 in 1972); Congressman Wilbur Mills ($15,000 in 1972); Senator Hugh Scott ($10,000 per year since 1960); and Senator Hubert Humphrey ($25,000 in 1968), McCLOY REPORT, *supra* note 67, at 70-74.

90. McCLOY REPORT, *supra* note 67, at 160.

continued prosperity in South Korea. Ultimately, Dorsey negotiated the price down to $3 million, which was finally paid.[91] This $3 million contribution was charged to the books of Bahamas X and written off as an expenditure from a general or miscellaneous expense account. Such accounts were ultimately consolidated with similar accounts for Gulf's 14 other subsidiaries which reported to corporate headquarters.[92]

In Italy, Gulf utilized another off the books fund to seek political influence. Between 1969 and 1972, Gulf made ten separate payments totaling $627,000 to three Italian publishing firms, which were either owned or controlled by various political parties. In recognition of these payments, Gulf's records reflected only expenses for "newspaper journalistic services."[93]

The Committee did not make definitive conclusions as to the legality of such contributions under the laws of the particular country. It did, however, conclude that:

> In any event, regardless of the propriety of motives and legality under local law, *the maintenance of off-the-books corporate accounts, wherever located, cannot be justified in a publicly owned company*. There is no control or accountability to the company or its outside auditors for either receipts or disbursements, and the true state of financial affairs of the company may be obscured, if only minimally, as in the case of a large corporation such as Gulf. Moreover, the possibilities for abuse are manifest.[94]

The Committee concluded by describing the role of certain key Gulf executives in these improper payments. As to the role of Dorsey, the Committee concluded that "[i]f Dorsey did not know of the nature and extent of Wild's unlawful activities, he perhaps chose to shut his eyes to what was going on."[95]

Prepared at a cost of $3 million, the Committee report proved fatal to the reign of Dorsey and others. As a direct result of the report, the directors of Gulf fired Dorsey, William L. Henry, president of Gulf Oil Real Estate Development Co., and Fred Deering, senior vice president.[96]

Other Questionable and Illegal Corporate Payments

Improper foreign corporate payments not directly related to the

91. *Id.* at 101.
92. *Id.* at 200-01.
93. *Id.* at 122-30.
94. *Id.* at 146 (emphasis added).
95. *Id.* at 279.
96. TIME, *supra* note 3, at 54.

political process constitute a third class of Commission action under the Management Fraud Program. Characteristic of this class is *Securities and Exchange Commission v. United Brands Company.*[97] In fact, it was in *United Brands* that the Commission first squarely confronted the existence of substantial corporate bribes to obtain or retain business abroad.

United Brands, formerly the United Fruit Company, is one of the world's largest producers of bananas. The company's earnings are substantially dependent upon the cultivation and sale of bananas. At the beginning of 1974, approximately 25 percent of its total banana production was concentrated in Honduras.[98] In April, 1974, Honduras imposed a new tax on banana exports.[99] Had the tax remained in effect, it would have increased United Brand's costs by approximately $20 million, a sum almost equal to its net income of the previous year.[100] In September, 1974, United Brands issued a letter to shareholders, stating that the company had reached a favorable settlement with Honduras concerning the export tax. That letter also included the following statement:

> [S]ome days ago, the Company reached an understanding with the Government of Honduras, under which the tax situation in that country was settled on the basis of the Company paying a tax of $.25 per box, with yearly escalations beginning in 1975, which may depend, in part, on the banana market at the relevant times. There are other terms involved in the settlement but the significant item is that the tax for the balance of this year was fixed at $.25 per box. . . .[101]

The "other terms involved" in the settlement were eventually revealed by United Brands on April 8, 1975.

At that time, the company announced that in order to win the tax reduction in 1974, it paid an unidentified official of the Republic of

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97. Securities and Exchange Commission v. United Brands Company, Civil No. 75-0509 (D.D.C. settled Jan. 27, 1976), SEC Lit. Rel. No. 7251 (Jan. 27, 1976). Unlike previous cases, however, the Commission's action here did not follow an investigation by the Watergate Special Prosecution Force. It was, rather, the suicide of Eli Black, the chief executive officer, on February 3, 1974, and a routine Commission inquiry thereafter, which led to this action.

98. Tracy, *How United Brands Survived the Banana War*, FORTUNE, July, 1976, at 145. Although United Brands is engaged in other operations, banana sales provide a significant percentage of the company's earnings. In 1975, banana sales accounted for only 30 percent of the company's sales of $2.2 billion, but provided 75 percent of the operating profits. *Id.*

99. SEC Complaint ¶ 9, Securities and Exchange Commission v. United Brands Co., Civil No. 75-0509 (D.D.C. filed April 9, 1975).

100. *United Brands Paid Bribe of $1.25 Million to Honduran Official*, Wall St. Jour., Apr. 9, 1975, at 1, col. 6.

101. SEC Complaint ¶ 10, Securities and Exchange Commission v. United Brands Co., Civil No. 75-0509 (D.D.C. filed April 9, 1975).

Honduras $1.25 million. The money was paid through a foreign subsidiary of the company, improperly characterized as "commissions" on the corporation's books and deposited in a Swiss bank account for the recipient. Payments of approximately $750,000 to government officials in Europe were also disclosed.[102]

One day later, on April 9, 1975, the Commission filed suit against United Brands. As in prior cases, the Commission charged that the defendant violated section 13 by filing annual, periodic and other statements which failed to disclose the existence of the payments, the arrangements pursuant to which they were made, or the falsification of the company's books associated with the payments.[103] For the first time, however, the Commission charged that the omissions also constituted violations of section 10(b) and rule 10b-5 thereunder. The addition of this count was apparently justified by the intentionally deceptive character of the defendant's filings and public statements after the settlement of its tax problems in Honduras.

After a long struggle, United Brands eventually consented, without admitting or denying, to the entry of a permanent injunction on January 27, 1976.[104] A separate Undertaking was also incorporated into the settlement. For the first time, a defendant consented to an injunction against future violations of both the reporting provisions and the anti-fraud provisions of the Exchange Act in connection with, among others, unlawful payments to foreign governmental officials. Not only was United Brands enjoined from failing to disclose false or fictitious entries on its books as a result of such payments, but it was also specifically enjoined from making materially false or fictitious entries on its books and records at any time. Finally, the company was required to maintain "adequate documentation" concerning all improper payments and the Commission was granted continuing access to such documents.[105]

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102. United Brands Form 8-K (April, 1975), SEC File No. 1-1550. The recipient of the payment was not identified; it is reported to have been General Oswaldo Lopez, the President of Honduras. Two weeks after the disclosure by United Brands, Lopez was deposed. He has denied ever receiving the money.

103. SEC Lit. Rel. No. 6827 (April 10, 1975). Although the Commission has yet to name an accounting firm in a case involving improper corporate payments, auditors have been named in private actions. Price Waterhouse, the independent auditor of United Brands, was named in a class action suit against United Brands based on violations of rule 10b-5. The Walsh Agency, Inc. v. United Brands Company, 75 Civ. 1760 (S.D.N.Y. filed April 10, 1975). *See generally* Causey, *Emerging Standards of Auditor Responsibility*, 51 ACCOUNTING REV. 19 (1976). *Cf.* Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Law And a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261, 277-78 (1974).

104. SEC Lit. Rel. No. 7251 (Jan. 27, 1976).

105. *Id.*

The Undertaking was equally stringent. It included the standard provision for an independent investigation and accounting by a special committee of the board composed of three outside directors. The procedures employed by that committee, as well as its final report, however, were to be reviewed by an independent party. United Brands further agreed to adopt, implement, and maintain a statement of policy concerning improper payments not inconsistent with the terms of the injunction. Finally, the company agreed that it would obtain the approval of the board of directors prior to any "unlawful expenditure of corporate funds to an official of any foreign government which is material in nature, effect or amount to its business."[106] To this was added the requirement that, prior to any such expenditure, United Brands publicly disclose in a Form 8-K all the details of the transaction, whether otherwise material or not.[107]

MATERIALITY

An analysis of the cases set forth above leads to a finding of several common denominators. It yields a picture of corporate conduct, in certain instances directed by management at the highest levels, which totally disregarded federal election laws and the laws of other countries.

Perhaps more significant than the mere violations were the methods utilized in their perpetration. Frequently, the payments derived from substantial pools of money that had literally been sucked out of the corporation's system of financial accountability. The funds were then diverted to accounts of overseas agents, Swiss bank accounts, Bahamian subsidiaries, and other places where detection by outside auditors or independent directors was difficult, if not impossible. These "slush funds" and the improper payments made from them were concealed by the creation of expenses for fictitious purposes or by false or misleading entries in the books of the corporations.

Such activity bears directly on the financial integrity of publicly-held corporations and the stewardship of management. Thus, these practices are of major concern, both to the Commission and to the public, in connection with assuring a system of full and fair corporate disclosure.

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106. *Id.*
107. *Id.*

Disclosure Philosophy

In promulgating the Securities Act, Congress approved the first in a series of federal securities statutes designed to provide "full and fair disclosure of the character of securities sold in interstate and foreign commerce."[108] The very cornerstone of the federal securities laws has been this disclosure philosophy.[109]

A. Public Interest and Protection of Investors

Congress, in enacting both the Securities Act and the Exchange Act, gave the Commission broad discretion in determining the matters which would come within the scope of this "full and fair disclosure" concept. In this regard, the Senate Report accompanying the Exchange Act commented that:

> The Commission is given complete discretion . . . to require in corporate reports only such information as it deems necessary or appropriate in the public interest or to protect investors.[110]

The basic canon providing the foundation for the Commission's disclosure process is found in Schedule A of the Securities Act,[111] which specifies the items of information to be supplied in registration statements for public offerings, with broad discretion in the Commission to vary the requirements or to add or subtract items. As former Chairman Garrett stated:

> In adopting Schedule A, Congress obviously posited as the typical prospective investor, a reasonable economic man whose needs and desires for information were basic, financial stuff: balance sheets and earnings statements, capital structure, rights of security holders, especially of securities being offered, a description of the business, major customers and contracts, litigation that might be costly, etc.[112]

108. Preamble, Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (1970).

109. Preamble, Securities Exchange Act of 1934, 15 U.S.C. § 78 *et seq.* (1970); REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, 88th Cong. 1st Sess. (1963).

110. S. REP. No. 792, 73d Cong., 2d Sess. 10 (1963). This congressional intent is embodied in section 10(c) of the Securities Act, 15 U.S.C. § 77j(c) which provides:

> Any prospectus shall contain such other information as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors.

See also section 12(b) of the Exchange Act, 15 U.S.C. § 781(b) (1970).

111. 15 U.S.C. § 77aa (1970).

112. *The Uses of Disclosure*, Address by Ray Garrett, Jr., in Washington, D.C., September 30, 1975, at 2. *See also* the House report preceding the Securities Act, which stated:

> The type of information required to be disclosed is of a character comparable to that demanded by competent bankers from their borrowers, and has been worked out in the light of these and other requirements.

In addition to the disclosure requirements of Schedule A, various provisions of the Exchange Act followed its theme. Section 12(b) of the Exchange Act provides that the Commission may require, in applications for the registration of securities, such information respecting the issuer's organization, financial structure, nature of business and financial statements as it deems "necessary or appropriate in the public interest or for the protection of investors."[113] Section 13 of the Exchange Act and the rules adopted thereunder require disclosure at the end of certain fiscal periods or at other specified times.[114] This section requires the issuer whose securities are registered under section 12 or covered under section 15(d)[115] to keep current the information in its application or registration statement and to file annual and quarterly reports in accordance with rules prescribed by the Commission "as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security." Likewise, section 14(a) of the Exchange Act prohibits the dissemination of proxy material in contravention of such rules as the Commission prescribes "as necessary or appropriate in the public interest or for the protection of investors."[116]

A term which is the common thread in most of these disclosure sections is "material information." In administering the disclosure process under the Securities Act and the Exchange Act, the Commission has required disclosure only of such information as it believes is important to the reasonable investor, *i.e.*, "material infor-

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H.R. REP. No. 85, 73d Cong., 1st Sess. 4 (1933).

The Supreme Court has recently given emphasis to the economic nature of securities transactions in United Housing Foundation v. Forman, 421 U.S. 837 (1975), stating:

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the *economic realities* underlying a transaction . . .

Id. at 849 (emphasis added).

113. 15 U.S.C. § 78l(b)(1) (1970).

114. For example, an annual report on Form 10-K, 17 C.F.R. § 249.310 (1976), must be filed within 90 days after the end of the fiscal year; a quarterly report on Form 10-Q, 17 C.F.R. § 249.308a (1976), must be filed within 45 days after the end of each of the first three quarters of each fiscal year; and a report on Form 8-K, 17 C.F.R. § 249.308 (1976), must be filed within 10 days after the close of each month during which any of the specified reportable events occur.

115. 15 U.S.C. § 78o(d) (1970), which provides that such reports are to be filed by companies which have filed registration statements under the Securities Act.

116. 15 U.S.C. § 78n (1970). It should be noted that the congressional purpose of enacting section 14 has been characterized as "to require fair opportunity for the operation of corporate suffrage," and therefore, the primacy of economic matters is somewhat less than in other disclosure sections. Securities and Exchange Commission v. Transamerica Corp., 163 F.2d 511, 518 (3d Cir. 1947), *cert. denied*, 332 U.S. 847 (1948). *See also* J. I. Case Co. v. Borak, 377 U.S. 426, 431-32 (1964); Securities Act Rel. No. 5627, at 14 (October 14, 1975).

mation."[117] Such a limitation has been deemed necessary in order to insure meaningful and useful disclosure of information of benefit to investors generally, without unreasonable cost to the registrants and their shareholders.[118] Thus, the doctrine of materiality may not be fixed in its terms nor limited by traditional concepts. Instead, it is a flexible tool providing the Commission with the necessary latitude to balance competing interests.

Neither the term "material information" nor the term "reasonable investor" is specifically defined under any of the sections of the Securities Act or the Exchange Act.[119] Accordingly, the Commission, and the public, look to judicial interpretations for guidance in this area.

B. The Reasonable Investor

The term "reasonable investor" is perhaps the easier of the two concepts to define. A reasonable investor has been defined by the Second Circuit Court of Appeals as including not only the long-term investor, but the Wall Street speculator as well.[120]

Such an approach is certainly appropriate in light of the Wheat Report,[121] which indicated that at the end of 1950, the Financial Analysts Federation had 2,422 members and that by the close of 1967 its membership had increased to 11,752. These are professional investors who need and require detailed, sophisticated information. While the long-term, amateur investor requires simplified and selective disclosure, which sometimes leads to a distorted picture of corporate reality, professional investors do not accept such simplification. They desire what has been termed by one writer as soft information: forward-looking statements about future events; information based on such evaluations as competence or integrity of man-

117. 17 C.F.R. § 230.405(l) (1976) defines the term material as being "those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." 17 C.F.R. §§ 230.408, 240.12b-20, 240.14a-9 (1976), also require disclosure in registration statements and periodic reports and proxies, of such additional information as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. *See also* Regulation S-X, 17 C.F.R. § 210.1-02(m) (1976); Statement of Accounting Principles Board, 3 CCH AICPA PROF. STAND. AC § 1025.15.

118. *See* SEC Securities Act Rel. No. 5627 at 18 (October 14, 1975), which contains the Commission's conclusions regarding disclosure of certain environmental matters in registration statements, reports, and other documents required to be filed under the federal securities laws.

119. While Congress did not specifically include a definition of the term material information within the framework of either the Securities Act or the Exchange Act, the Commission has promulgated rules, *supra* note 117, which have attempted to define materiality.

120. Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied, sub nom.*, Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969).

121. *SEC*, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (1969) [hereinafter cited as WHEAT REPORT].

agement; and statements of motive, purpose, or intent.[122]

The above distinction suggests that different levels of disclosure may be appropriate depending upon the category of investor. In recognizing these differing levels of disclosure, the Commission has required certain information for one level

> primarily designed to assist professional analysts who have the responsibility of developing an understanding, in depth, of corporate activity. It is not primarily intended to serve the direct needs of the "average investor." Such an investor does not usually have the time to study or the training necessary to fully understand the data which are called for. . . .[123]

Since recognition is thus given to the professional investor as a "reasonable investor," does this term also include other categories of investors, specifically, the so-called "ethical investor"? This category of investor was defined in *Natural Resources Defense Council, Inc. v. Securities and Exchange Commission*, to include those

> who want to invest their assets in firms which are concerned about and acting on environmental problems of the nation. This attitude may be based purely upon a concern for the environment; but it may also proceed from the recognition that awareness of and sensitivity to environmental problems is the mark of intelligent management. Whatever their motive, this Court is not prepared to say that they are not rational investors and that the information they seek is not material information within the meaning of the securities law.[124]

The court in this case ordered the Commission "to undertake further rulemaking action to bring the Commission's corporate disclosure regulations into full compliance with the letter and spirit of NEPA."[125]

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122. Schneider, *Nuts, Grits and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972). *See also* Mundheim, *Selected Trends in Disclosure Requirements for Public Corporations*, 3 SEC. REG. 3, 16 (1975); SEC Securities Act Rel. No. 5362 (Feb. 2, 1973).

123. SEC Securities Act Rel. No. 5427 (October 4, 1973), [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,519, at 83,425.

124. 389 F. Supp. 689, 700 (D.D.C. 1974). This case involved the Commission's adoption of SEC Securities Act Rel. No. 5386 (April 20, 1973) concerning disclosure of the material effects of compliance with federal, state and local environmental and anti-pollution laws on capital expenditures, earnings, and competitive position. The court held that the adoption of this Release and the denial, by the Commission, of plaintiff's petition for equal employment rulemaking violated § 706 of the Administrative Procedure Act, 5 U.S.C. § 706 (1970).

125. 389 F. Supp. at 693. In 1970, Congress enacted the National Environmental Policy Act (NEPA), 42 U.S.C. § 4321 *et seq.*, which declares that it is the policy of the federal government to use all practicable means and measures to protect environmental values. It also stated that "to the fullest extent possible . . . the policies, regulations and public laws of the United States shall be interpreted and administered in accordance with the policies of

In response, the Commission held public hearings and received written comments concerning this entire area. Following the public proceeding, the Commission issued its conclusions as to disclosure of environmental effects of corporate activities and disclosure of other social information. Regarding the "ethical investor," the Commission concluded that disclosure which serves only a limited sector of the investing public is inappropriate since the cost to the companies, which is ultimately borne by the shareholders, generally outweighs the resulting benefits to reasonable investors.[126] Whether the balance struck by the Commission in weighing the interests of the ethical investor will be sustained by the courts is uncertain.

It seems clear, however, that the term "reasonable investor" is sufficiently broad to cover those concerned with the area of questionable or illegal corporate payments. One argument in favor of this conclusion is that a reasonable investor might consider it important to know that management is misusing corporate funds to engage in conduct involving possible criminal activity. This is not a sufficient answer, however, if one is to adopt the Commission's position concerning the "ethical investor," since it would be equally important for such investor to know that management may be misusing corporate funds by failing to adopt a corporate environmental policy in accordance with NEPA.

A second argument, and a much more persuasive one, is that a program of illegal or improper payments which leads to a process of "laundering" money to produce unaccounted-for cash and the falsification of accounts is certainly information that would be important to any reasonable investor. It is evident that a reasonable investor is concerned with the financial integrity and accountability of the corporation in which he invests.

C. Material Information

Though the reasonable investor concept may be more readily susceptible to definition, the term material information is not so easily defined.

> The term has always been a slippery, elusive and uncertain one. Like the concept of negligence, the value of the concept of materi-

the NEPA [section 102(1)]." 42 U.S.C. § 4332 (1970).

126. SEC Securities Act Rel. No. 5627 at 45-46 (October 14, 1975). In the Commission's hearings on this matter, over 100 different "social matters" were submitted in which "ethical" investors were said to be interested. These included such things as: charitable contributions, community activities, commitment to the "human community," "good things a company has done," and the registrant's impact on the world food crisis.

ality derives from its very breadth, imprecision and defiance of exact definition. It reflects the complexity of human affairs, the multitude of situations in which human beings find themselves involved and the multiplicity of relationships that they create. As with negligence, so with materiality, we have defined the concept in terms of a hypothetical human being possessed of certain qualities of prudence and judgment that at least sometimes escapes us as individuals.[127]

Thus, the disclosure principles embodied within the term material information are not "unqualified absolutes."[128] This is readily apparent from a review of various court decisions which have differed radically on the determination of a proper standard of materiality.

In *Mills v. Electric Auto-Lite Co.*,[129] the Supreme Court stated that the standard of materiality, in the context of a proxy dispute[130]

> embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).[131]

Two years later, the Supreme Court considered *Affiliated Ute Citizens v. United States*.[132] This case involved a suit for damages for alleged violations of the anti-fraud provisions of the Exchange Act growing out of failure to disclose certain facts in connection with the purchase of securities, not in the context of a proxy dispute. The

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127. *The Slippery Slope of Materiality*, Address by A. A. Sommer, Jr., in New York, N.Y. Dec. 8, 1975, at 1-2.

128. *The Uses of Disclosure*, Garrett, *supra* note 112, at 5.

129. 396 U.S. 375 (1970).

130. It has been suggested that courts confronting disclosure in proxy or tender offer situations might apply different standards of materiality than they would in the context of a prospectus. Such a distinction is suggested in Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), where it was stated that:

> Being a formal and legally required document, a prospectus must satisfy a high standard of disclosure—*i.e.*, disclosure is required when only a relatively small percentage of traders would want to know before making a decision.

Id. at 571. *See also* Electronic Speciality Co. v. International Controls Corp., 409 F.2d 937, 948 (2d Cir. 1969).

131. 396 U.S. at 384 (footnotes omitted).

132. 406 U.S. 128 (1972).

Court held that all that is necessary in order to establish a cause of action is that the facts withheld be material in the sense that a "reasonable investor *might have* considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact."[133]

Following these two cases, uncertainty developed as to the proper test of materiality. Three differing standards evolved in the various circuit courts of appeal. The Second and Fifth Circuits applied a common law standard to actions wherein materiality was an issue.[134] Such a test was based on the *Restatement of Torts*, where a fact is deemed "material" if "its existence or nonexistence is a matter to which a reasonable man *would* attach importance in determining his choice of action in the transaction in question."[135] The Second Circuit, however, also gave approval to a second standard of materiality. That standard was

> whether, taking a properly realistic view, there is a *substantial likelihood* that the misstatement or omission may have led a stockholder to grant a proxy to the solicitor or to withhold one from the other side, whereas in the absence of this he would have taken a contrary course.[136]

Still a third test of materiality was enunciated by the Seventh Circuit wherein the court specifically rejected both the "would have" and "substantial likelihood" tests of materiality, and held that:

> We believe that policies which underlie § 14(a) and Rule 14a-9 are best served by a test that includes all facts which a reasonable stockholder *might* consider important.[137]

Thus, three differing standards developed amongst the various circuits: whether the fact might affect, would affect, or would have a substantial likelihood of affecting a reasonable investor.

These differing tests of materiality presented important questions, particularly in the area of unlawful or improper corporate payments. The application of one test, as opposed to another, could

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133. *Id.* at 154 (emphasis added).

134. *See* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 603-04 (5th Cir. 1974).

135. RESTATEMENT OF TORTS, § 538 (2)(a) (1938) (emphasis added).

136. General Time Corp. v. Talley Industries, Inc., 403 F.2d 159, 162 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969) (emphasis added).

137. Northway, Inc. v. TSC Industries, Inc., 512 F.2d 324, 330 (7th Cir. 1975), *rev'd*, 96 S.Ct. 2126 (1976) (emphasis added).

yield differing results. As was noted in *Northway, Inc. v. TSC Industries, Inc.*:

> Different results could flow from a test requiring only that the omitted fact "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote" than would flow from a test requiring that the fact have "a significant *propensity* to affect the voting process." On a motion for summary judgment, the "might have" test would ask whether a reasonable mind could conclude that the omitted fact is so irrelevant that it would never reasonably be considered important. The "significant propensity" test would ask whether a reasonable mind could conclude that the fact is less than significant in its potential to affect the voting process. Many facts which are relevant within the first test could reasonably be said to have less than a significant propensity to affect the voting process taken as a whole, even though for some few stockholders these same facts could be determinative.[138]

It was, in part, because of this difficulty that the Commission submitted an amicus curiae brief after certiorari was granted by the Supreme Court in *TSC*. In its brief, the Commission stated: "the appropriate standard . . . is whether the misstatement or omission has a significant propensity to affect the judgment of a reasonable shareholder in the process of deciding how to vote."[139]

The Supreme Court adopted the standard set forth by the Commission and held that:

> The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.[140]

The Court recognized that if the standard of materiality were set too low,

> not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it to simply bury the shareholder in an avalanche of trivial information—a result that is hardly conducive to informed decision making.[141]

By the same token, the Court adopted an approach which was not

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138. 512 F.2d at 330 (footnotes omitted).

139. 96 S.Ct. at 2133 n.10. Brief for the Securities and Exchange Commission as Amicus Curiae at 13, TSC Industries, Inc. v. Northway, Inc., 96 S.Ct. 2126 (1976).

140. 96 S.Ct. at 2133. It remains unclear whether the Court has adopted a test of materiality which resolves prior inconsistencies. The combination of the terms "substantial likelihood" and "would consider" in one definition may cause future uncertainty.

141. *Id.* at 2132-33.

nearly as restrictive as the common law standard formulated by the Second Circuit, The Court acknowledged that

> in view of the prophylactic purpose of the Rule [14a-9] and the fact that the content of the proxy statement is within management's control, it is appropriate that these doubts be resolved in favor of those the statute is designed to protect.[142]

Materiality, Public Interest, and Undisclosed Corporate Payments

Under the test adopted in *TSC*, it would seem that the federal securities laws are sufficiently broad to justify the Commission's actions in seeking injunctive relief against undisclosed questionable or illegal corporate payments. This is particularly so in light of the fact that the standard adopted by the Supreme Court was the standard being urged by the Commission.

In the cases brought by the Commission concerning the issue of improper payments, the amounts of the undisclosed payments, considered in relation to the income of the company, its net worth, its assets or other financial measurements have been relatively small, even in terms of conventional standards of materiality.[143] In one of the Commission's more recent actions, for example, *Securities and Exchange Commission v. Missouri Public Service Co.*,[144] the Commission alleged that only $68,000 was diverted through a system of corporate reimbursements to senior employees who contributed to a "good government fund," apparently conceived and controlled by those same officers. The Complaint further alleged that only $51,000 was ultimately disbursed for unlawful political contributions. During fiscal 1975, by contrast, Missouri Public Service Co. had revenues in excess of $70 million, earnings of more than $7 million, and total assets of over $238 million.

When, however, materiality is at issue, the entire course of corporate conduct, rather than the size of any particular transaction, must be considered. In the area of corporate suffrage, this is especially true. The exercise of corporate suffrage requires, among other things, an evaluation of management's stewardship of corporate assets. The Senate Report on the proxy solicitation provisions of the Exchange Act concluded:

> In order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential

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142. *Id.* at 2132.

143. *See generally* Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied sub. nom.*, Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969).

144. Civil No. 76-132-W-2 (W.D. Mo. filed Feb. 27, 1976), SEC Lit. Rel. No. 7299 (March 4, 1976).

> that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which were decided at stockholders' meetings.[145]

Implicit in this conclusion is the belief that corporate managers are stewards acting on behalf of the shareholders, and that shareholders are entitled to the honest use of, and accounting for, funds entrusted to such stewards.

The Commission cast these concepts in the following manner:

> Of cardinal importance in any business is the quality of its management. . . . [T]he development of disclosure standards adequate for informed appraisal of management's ability and integrity is a difficult task. How do you tell a "good" business manager from a "bad" one in a piece of paper? Managerial talent consists of personal attributes, essentially subjective in nature, that frequently defy meaningful analysis through the impersonal medium of a prospectus. . . .
>
> Evaluation of the quality of management—to whatever extent it is possible—is an essential ingredient of informed investment decision. A need so important cannot be ignored, and in a variety of ways the disclosure requirements of the Securities Act furnish factual information to fill this need.[146]

Pursuing the need for an investor to be informed in order to make an evaluation concerning management's integrity, the Commission's Division of Corporation Finance concluded that a conviction for illegal political contributions was a material fact. The Division stated that:

> [T]he conviction of a corporation and/or its officers or directors for having made illegal campaign contributions in violation of 18 U.S.C. Section 610 is a material fact that should be disclosed to the public and specifically to shareholders, particularly in the context of a proxy statement where shareholders are being asked to vote for management. Such a conviction is material to an evalua-

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145. S. REP. No. 792, 73d Cong., 2d Sess. 12 (1934).

146. *In re* Franchard Corp., 42 S.E.C. 163, 169-70 (1964). As the Commission further pointed out in *Franchard*:

> Appraisals of competency begin with information concerning management's past business experience, which is elicited by requirements that a prospectus state the offices and positions held with the issuer by each executive officer within the last 5 years. . . . To permit judgments whether the corporation's affairs are likely to be conducted in the interest of public shareholders, the registration requirements elicit information as to the interests of insiders which may conflict with their duty of loyalty to the corporation. Disclosures are also required with respect to the remuneration and other benefits paid or proposed to be paid to management as well as material transactions between the corporation and its officers, directors, holders of more than 10% of its stock, and their associates.

Id. at 170-71 (footnotes omitted).

> tion of the integrity of the management of the corporation as it relates to the operation of the corporation and the use of corporate funds.[147]

The question now presented is whether the payment of corporate funds for unlawful or improper purposes, even where no criminal action has been taken, fits within these disclosure concepts. Is it appropriate for the Commission to require disclosure of such payments in corporate filings?

It certainly would not be appropriate disclosure if the Commission were merely attempting to prohibit all such payments. This is not the case. Various commissioners have asserted that the Commission is not on a moral crusade to enforce its conceptions of corporate ethics. Indeed, former Chairman Garrett has stated that:

> [W]e are not concerned with corporate morality as such—just disclosure of material facts. It offends some within our own ranks to make this assertion. How can a government agency with such widespread responsibility for working toward the public interest and the interest of investors disclaim any concern for corporate morality? How, indeed! We have showed an abiding and increasing concern for corporate morality in the treatment of investors, present and potential. We have not shown the same concern for external morality, so to speak—how the corporation treats the rest of the world—unless it is breaking the law in a manner and to a degree that might be expensive for investors, in terms of cost or otherwise. Then, but only then, we have said investors should know.[148]

This statement has been echoed by the present Commission Chairman, Roderick M. Hills. In a recent speech, he stated that "the fact that we cannot legislate morality does not mean that we cannot ferret out immorality when it has a material impact on business."[149]

It has always been true, however, that as a collateral effect, the disclosure requirements have not only tended to inhibit certain illegal activity, but also tended to discourage conduct which although technically legal, was not entirely consistent with the highest fiduciary standards of behavior.[150] These effects were acknowledged in

147. SEC Securities Act Rel. No. 5466 (March 8, 1974). It should be noted that in enforcement cases brought by the Commission, the approach is much broader. In these cases, materiality is not dependent upon a conviction of the corporation or its officers or directors for illegal acts. See note 49 *supra* and accompanying text.

148. Garrett, *Homily, supra* note 24, at 18-19.

149. *Corporate Morality—Whose Business Is It*, Address by Roderick M. Hills, in Los Angeles, Calif., April 13, 1976, at 16.

150. *See* Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 408-09 (1962).

the Wheat Report, which involved a reappraisal of the Commission's administrative policies under the Securities Act and the Exchange Act concerning the disclosure process. The Wheat Report indicates that:

> Although basically intended to inform, the disclosure provisions of the early Acts were expected to accomplish more. Their principal architects were disciples of Justice Brandeis who, in 1913, made the most famous observation in *Other People's Money* that:
>
> > "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants. . . ."
>
> The fact that there is a significant degree of truth in such observations is attested by all who have worked with the disclosure provisions of the '33 and '34 Acts. The registration process has sometimes been referred to as a housecleaning: one of its most valuable consequences is the elimination of conflicts of interest and questionable business practices which Justice Frankfurter once termed "a shrinking quality."[151]

Such effects, of course, are only a consequence of disclosure, and not a basis for disclosure of conduct clearly and directly related to investor interest.

Application of the Materiality Standard

The materiality of questionable or illegal payments has always been the central question. In making determinations of materiality, the Commission quickly took the position that measuring questionable or illegal payments strictly in terms of revenues, profits or assets was too narrow a test of materiality. The size of a payment, in other words, may not be decisive since the concept of materiality necessarily includes qualitative as well as quantitative judgments.[152] Accordingly, the Commission adopted a much broader approach, focusing on the character and consequences of the payments and not upon their size. Several arguments were advanced in support of this view of materiality.

In the first place, it was argued, the existence of questionable or illegal payments may jeopardize substantial corporate assets.[153]

151. WHEAT REPORT, *supra* note 121, at 50-51 (footnotes omitted).

152. *See, e.g.*, SEC Accounting Series Rel. 41 (1942). This broad approach to the concept of materiality is entirely consistent with the admonishments of the Supreme Court that the securities law must be read "flexibly, not technically and restrictively." Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Co., 404 U.S. 6, 12 (1971); Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963). *See also* AICPA, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU §§ 150.03, 411.04, 509.16 (1976).

153. The Commission has historically required the disclosure of contingent liabilities

This is particularly true where the payments are illegal under local law and exposure may result in the expropriation of corporate assets. In many parts of the world, moreover, the threat of expropriation is quite real. In at least one case, for example, payments by a major oil company in one country were used as the basis for the expropriation of its property in another country.[154] Although some view this as an argument against disclosure, the peril of such exposure through other sources presents the continuing potential for shareholder loss, with the accompanying need for disclosure.

A variation of this argument in favor of materiality focuses upon the quality of a registrant's earnings.[155] If such payments are necessary to secure or maintain significant business overseas, they should be disclosed since that business is peculiarly unstable or less predictable than a business which depends upon superior technology, salesmanship, or management.

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under Regulation S-X, 17 C.F.R. § 210.3-16(i)(1976). *See also* Statement of Financial Accounting Standards Number 5, *Accounting For Contingencies*, in 3 CCH AICPA PROF. STANDS. AC § 4311 (1976), which defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." One example of a loss contingency cited by the statement is "the threat of expropriation of assets." The statement sets forth certain standards for the accrual and disclosure of loss contingencies. A loss contingency must be accrued (1) if it is probable at the date of the financial statement that an asset has been impaired or a liability incurred; and (2) the amount of the loss can be reasonably estimated. Disclosure may also be required, even if no accrual is necessary, where there is a reasonable possibility that a loss may have been incurred.

The contingent impact of illegal corporate conduct was considered in National Resources Defense Council, Inc. v. Securities and Exchange Commission, 389 F. Supp. 689, 700 (D.D.C. 1974) wherein the court noted:

> Moreover, this Court is not prepared to say that a corporation's adverse impact on the environment or its equal employment practices may not directly lead to an unfortunate financial condition in the near future. There is substantial risk that failure to adjust corporate behavior to federal standards will result in severe monetary sanctions.

See also Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Company, Inc., 476 F.2d 687, 697 (2d Cir. 1973); Elco Corporation v. Microdot, Inc., 360 F. Supp. 741, 752 (D. Del. 1973).

154. SEC REPORT, *supra* note 22, at 5. Similarly, the disclosure of United Brands' payments in Honduras resulted in the virtual expropriation of its property in Panama and a 40 percent decline in the value of its common stock.

155. The Commission's interest in the quality of a registrant's earnings is reflected in various disclosure requirements. For example, sales and earnings must be broken down by line of business. SEC Securities Act Rel. No. 4988 (July 14, 1969). Financial statements must include a statement of the source and application of funds. SEC Securities Act Rel. No. 5135 (Feb. 26, 1971). The impact of tax elections on financial statements must be disclosed. SEC Securities Act Rel. No. 5344 (Dec. 18, 1972). And, all unusual risks and uncertainties associated with a registrant's business must be adequately reported. SEC Accounting Series Rel. 166 (Dec. 23, 1974).

This view of materiality is evident in several of the Commission's actions involving questionable or illegal payments abroad. In *United Brands*[156] for example, the Commission alleged that the company failed to disclose a $1.25 million payment to high government officials of the Republic of Honduras in exchange for favorable tax treatment of United Brand's banana operations in that country.[157] Though the size of the payment was not itself material, it was clear that a significant flow of earnings was directly dependent upon it. In fact, the material character of the payment was best described by United Brands, which acknowledged that disclosure of the payment could result in "a material reduction in future earnings and a loss of substantial corporate assets, which, in turn, could affect the continuity of the operations of the company."[158]

The Commission's complaint in *Securities and Exchange Commission v. Lockheed Aircraft Corporation*[159] is another illustration of this aspect of materiality. The complaint alleged, *inter alia*, that at least since 1968, Lockheed had entered into "arrangements" with consultants, commission agents, and others where an excess of $200 million had been committed or disbursed.[160] Approximately $25 million of that amount was used for secret payments to foreign government officials.[161] While the identities of the recipients were not specified, these secret payments were made, according to the complaint, to acquire or retain contracts with foreign government customers. As a result, the complaint charged that Lockheed had failed to disclose "the possible business risks attendant to the procurement of contracts" by such payments.[162]

A second argument in favor of the disclosure of questionable or improper payments flow from the Commission's decision in *Franchard Corporation*.[163] The Commission there concluded that certain activities of management should have been disclosed since they were "germane to an evaluation of the integrity of management. This quality is always a material factor."[164] In light of *Franchard*

156. SEC Lit Rel. No. 6827 (Apr. 10, 1975).

157. *Id.*

158. Wall St. Jour., Apr. 9, 1975, at 1, col. 6.

159. SEC Lit. Rel. No. 7355 (Apr. 13, 1976), CCH FED. SEC. L. REP. ¶ 95,509 (D.D.C. 1976).

160. SEC Complaint ¶ 14, Securities and Exchange Commission v. Lockheed Aircraft Corp., Civil No. 76-0611 (D.D.C. filed April 13, 1976).

161. *Id.* at ¶ 11.

162. *Id.* at ¶ 15.

163. 42 S.E.C. 164 (1964).

164. *Id.* at 172. *See also* Robinson v. Penn Central Company, 336 F. Supp. 655, 658 (E.D. Pa. 1971); Beatty v. Bright, 318 F. Supp. 169, 173 (S.D. Iowa 1970).

then, questionable or illegal payments, authorized or condoned by senior corporate officers, may reflect upon the integrity of their management and upon the character of their stewardship of corporate assets and therefore demand disclosure.

Nondisclosure of information relating to the integrity of management was one basis for the Commission action against Emersons, Ltd.[165] The material omissions alleged in that action included the failure to disclose that the president of the company was receiving payments from beer suppliers to induce Emerson to purchase their products for resale in its restaurants. A substantial amount of these funds were later used by the president for non-business purposes. Thus, this defalcation by management was deemed by the Commission to constitute a disclosable event.

Finally, in the cases examined by the staff, the disbursements of questionable or illegal payments were almost invariably accompanied by the falsification of corporate records. It was argued that this conduct, perhaps more than anything else, related to a cognizable investor interest—the reliability and integrity of the corporate books and records. In the Commission's view, this is an essential component of the disclosure system. As former Commissioner Sommer once stated:

> Basic is the idea that all of the funds belonging to the corporation, which in turn belongs to the shareholders, are accounted for within the corporation's system of financial accountability.
>
> It becomes a matter of great concern therefore when we find that significant amounts of money float around outside this system of corporate accountability and are used by one or two or a very small coterie of officers without any necessity to account for that use through normal channels. When such is done, when significant amounts of money are extracted from the system and the uses of the money disguised by false bookkeeping entries, mislabeling, phony subsidiaries and Swiss bank accounts, I think that fact is material to shareholders and should be disclosed.[166]

165. Securities and Exchange Commission v. Emersons, Ltd., SEC Lit. Rel. No. 7392 (May 11, 1976).

166. *The Limits of Disclosure*, Address by A. A. Sommer, Jr., in Philadelphia, Pa., June 24, 1975, at 7-8. Sommer's statement is foreshadowed in Cooke v. Teleprompter Corporation, 334 F. Supp. 467 (S.D.N.Y. 1971). In *Cooke*, certain information sent to shareholders during a proxy solicitation was found to be incomplete and misleading, since it did not, among other things, fully disclose management's role in the bribery of municipal officials. The court concluded:

> A listed American corporation dealing with municipal officials is simply not supposed to submit to extortion. If threatened with extortion, an officer of the corporation should report the attempted crime to State or Federal authorities. No disclosure has been made as to how the money paid was shown on the books and records

It is this aspect of materiality which is common to all of the Commission's actions. Though other elements of materiality may be and often are present, the falsification of records alone provides an independent basis for Commission action. Thus, in *Securities and Exchange Commission v. Waste Management, Inc.*,[167] an undisclosed political contribution of $35,000 in a foreign country was actionable because the contribution had been improperly capitalized on the company's books and records as the cost of a landfill permit. Likewise, in *Securities and Exchange Commission v. Firestone Tire and Rubber Company*,[168] the Commission alleged, in part, that the company failed to disclose a payment of $39,600 to Mexican officials to win price increases in that country. The payment, funneled through a Mexican trade association, was concealed on the books of the company's Mexican subsidiary as a disbursement for engineering services provided to the subsidiary.

From these and other cases, certain factors appear to be decisive in the Commission's determination of materiality. These include the method by which the payments are made, the impact of the payments, the purpose for which they are made, and the knowledge or acquiescence of senior management.

THE VOLUNTARY DISCLOSURE PROGRAM

Never ask of money spent
Where the spender thinks it went.
Nobody was ever meant
To remember or invent
What he did with every cent.

Robert Frost, *The Hardship of Accounting*

As the Commission's investigations proceeded, it soon became apparent that the Commission could not conduct a systematic investigation of every multinational corporation which might have made improper payments. The extent of the practices involved, the

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of TPT [Teleprompter]. Presumably, this can be developed by discovery in this action, but money paid as bribes or extortion payments to American public officials is not a legitimate corporate expense or deduction for income tax purposes (26 U.S.C. § 162(c)) and if these payments were charged off in some guise as a legitimate corporate expense, this is again a factor which the shareholder might wish to consider in reaching his conclusion as to who should control the corporation.

Id. at 472.

167. Civil No. 76-0496 (D.D.C. filed March 26, 1976), SEC Lit. Rel. No. 7333 (Mar. 29, 1976).

168. Civil No. 76-1064 (D.D.C. filed June 15, 1976), SEC Lit. Rel. No. 7443 (Jun. 17, 1976). Wall St. Jour., June 16, 1976, at 6, col. 2.

number of registered companies engaged in foreign operations, and the difficulties of proof all discouraged the adoption of a formal program to expose all corporate payoffs. With its limited staff and resources, the Commission was not equipped for such a project, particularly in those cases where funds were generated and maintained off the books and records of the company.[169]

Beyond that, the Commission met increasing resistance from companies unwilling to produce sensitive records relating to foreign payoffs for fear of subsequent disclosure, particularly where those records identified specific recipients.[170] The Commission itself, moreover, was not insensitive to the dilemmas faced by public companies doing business abroad. As former Chairman Garrett observed, the Commission was "not happy at the thought of simply more investigations, more consent decrees, and more painful exposure without the development of sound policy guidelines for business abroad."[171]

Recognizing that the critical issue in past cases was the requirement that any disclosure include a full accounting, complete with the identification of all recipients,[172] certain Commissioners pro-

169. As BUSINESS WEEK observed, "bribery and kickbacks appear so extensive that the agency could investigate indefinitely." *The Corporate Rush to Confess All, Disclosure of Illegal Practices to SEC*, BUSINESS WEEK, Feb. 23, 1976, at 22.

170. Securities and Exchange Commission v. Lockheed Aircraft Corp., 404 F. Supp. 651 (D.D.C. 1975) (subpoena enforcement action). Conversely, on July 23, 1976, Goodyear Tire and Rubber Co. filed suit to block the Commission's investigation into the company's foreign and domestic payments. Among other things, Goodyear alleged that the disclosure of information collected by the staff of the Commission "will cause immediate and irreparable injury, loss and damage and unreasonably risk the life and liberty of individual plaintiffs and employees of plaintiff . . ." BNA SEC. REG. & L. REP., No. 363, A-6 (1976). Other companies have also resisted production of documents subpoenaed by the staff of the Commission for similar reasons.

Although evidentiary material gathered by the staff during an investigation is ordinarily non-public, 17 C.F.R. § 203.2 (1976), recent amendments to the Freedom of Information Act (FOIA), 5 U.S.C. § 552 (Supp. IV, 1974), have provided increased access to governmental records by members of the public. As a result of rules adopted by the Commission pursuant to the FOIA, evidentiary materials may now be made available to the public once all enforcement proceedings are terminated. SEC Securities Act Rel. No. 5571 (Feb. 21, 1975). *See In re* John A. Jenkins, FOIA Rel. No. 11 (June 11, 1975). *In re* I. Walton Bader, SEC FOIA Rel. No. 1 (Apr. 3, 1975). *See also* Mathews, *Effective Defense of SEC Investigations: Laying the Foundation for Successful Disposition of Subsequent Civil, Administrative and Criminal Proceedings*, 24 EMORY L.J. 567, 611-18 (1975).

171. Garrett, *Homily*, *supra* note 24, at 27.

172. *See, e.g.*, Phillips Petroleum Company, Form 8-K (Sept. 1975), SEC File No. 1-720, at 5, 19-21. The requirement for a full accounting was once expressed by the Director of the Commission's Division of Enforcement in the following terms:

> We don't know what the stewardship of this money is. We don't know if it's been given to the officials of some foreign government, as the company tells us, or if it came back into this country and went into someone's backyard as a swimming pool.

Wall St. Jour., Oct. 22, 1975, at 4, col. 3.

posed a compromise: registered companies could escape, or at least reduce the risk of, enforcement actions by voluntarily reporting questionable or illegal payments to the staff and the public. In exchange, such companies would be required to disclose questionable or illegal payments only in general terms, omitting specific details such as the location or identity of the recipients.

This approach, frequently referred to as the "Voluntary Disclosure Program," was originally articulated by Commissioner Loomis on July 17, 1975, in a prepared statement made for a House subcommittee on international economic policy.[173] It grew out of an increasing recognition that perhaps full disclosure was more costly than it was worth to investors; that perhaps the benefits of disclosure could be achieved without the painful consequences to which full disclosure might lead, *e.g.*, the loss of significant assets, revenues, or earnings. Central to this proposal was the belief that any conflict between the interests of business and the interests of investors could be amicably resolved. As former Commissioner Sommer noted:

> It seems to me an investor can be told all he really needs in assessing an investment or proposal without compelling disclosure of information that may have the unfortunate impacts I have suggested. If the Commission can develop such a mode of disclosure, then I think corporations may begin cleaning out their houses voluntarily. . . .[174]

The resolution lay in what has been called "generic disclosure,"[175] *i.e.*, disclosure couched in nonspecific terms relating only the general nature of the payments in question, without a specific characterization of each particular payment. In the beginning, under the Loomis plan, corporations believing that improper payments had been made could become candidates for the voluntary program by taking certain steps, including:

> (1) conducting a careful internal investigation under the auspices of those not involved, following the pattern set in the enforcement cases previously settled;
>
> (2) presenting the findings of such investigation to the company's board, which would determine what actions, if any, were appropriate; and

173. Statement by Commissioner Phillip A. Loomis, Jr., *House Hearings*, *supra* note 9, at 64.

174. *Crisis and the Corporation Community*, Address by A. A. Sommer, Jr., in Aspen, Colo. July 21, 1975, at 9.

175. *Id.*

(3) presenting the facts to the Commission's staff for review and discussion of the adequacy of any proposed disclosure.[176]

Loomis concluded his description with a warning that the voluntary program was not necessarily a guaranteed "safe harbor" for all:

> While our enforcement action in this area will continue . . . the foregoing procedure could lessen the need for enforcement action in particular cases, especially where the Commission is informed in advance that a company which is not now under investigation will proceed in this manner.[17]

Although Loomis' description was silent on the exact disclosures that would be required by the Commission under the voluntary program, former Commissioner Sommer suggested that:

> Such a pattern would require the disclosure by corporations of the extent to which their business overseas depended upon or had been secured as the result of payments disclosure of which would jeopardize that business; the names of the recipients and the countries in which the related business was done would not be demanded and the payments would not have to be characterized otherwise than by indicating that, to the extent true, their detailed disclosure or their discontinuance would adversely impact the business to which they related. The disclosure would indicate the approximate total volume of business, and the profitability of it, related to such payments, without detailed narration. In the past we have usually required that an issuer in disclosing "let it all hang out." I would suggest in these matters we should somewhat more discerningly decide what an investor really wants to know and not require disclosure of details of only peripheral importance to his investment decisions.[178]

These suggested requirements were reiterated in a speech by Sommer in July, 1975, in which he noted that the program was available only to companies not presently under investigation.[179]

Nonetheless, since the exact requirements of disclosure were uncertain and since the Commission had not foreclosed the possibility of subsequent enforcement action, volunteers were reluctant to come forward. In September, 1975, however, Cities Services Company, a major oil company, became the first volunteer, disclosing improper payments in a registration statement and in a Form 8-K under Item 13, "Other Materially Important Events."[180] As reported

176. *House Hearings*, *supra* note 9, at 66.
177. *Id.* at 64.
178. Sommer, *The Limits of Disclosure*, *supra* note 166, at 17.
179. Sommer, *Crisis and the Corporate Community*, *supra* note 174, at 10.
180. SEC File No. 1-1093.

in the Form 8-K, the company initiated an inquiry in May, 1975, to determine whether corporate funds had been used to make political campaign contributions or other illegal payments abroad. The inquiry, conducted with outside counsel, disclosed that the company had made contributions of $30,000 to foreign political parties; that these payments had been improperly recorded on the corporation's books, but only after approval was received from the company's general counsel and a vice president; that $15,000 had been paid to a lobbyist and improperly recorded as a technical service charge; and that a $600,000 unrecorded slush fund had been maintained by a foreign subsidiary.[181]

These findings were presented to the company's board in August, 1975. At that time, the board directed an expanded inquiry, under the supervision of the Audit Committee, assisted by outside legal counsel, into the company's entire activities for the preceding 5 years. The board also directed management to issue a "declaration of cessation," stating that the use of corporate funds for any unlawful or improper purpose was prohibited, and that no undisclosed funds were to be established nor false entries made on company books. The company then adopted a policy that all arrangements for the generation of monies not recorded on the company's books be terminated. The company noted that the final report would be filed with the Commission and all documents made available to staff. However, the company's Form 8-K did not disclose the identity of the subsidiary involved, the site or sites of any payments, or the identity of the recipients. It did state management's belief that no payment was material.[182]

Cities Services' disclosure became the standard for later participants under the voluntary program. Former Chairman Garrett identified the elements of this program which could lessen the need for enforcement action:

> [T]he board of directors has adopted a resolution directing a cessation of all such improper payments in the future. The company has further assured us that the payments do not involve any business activity in the particular country that makes a material contribution to the company's revenues or income nor are a material amount of the company's assets located in that country. Further, it appears that the payments do not involve any defalcations. Also, the company has undertaken to conduct an independent investigation to ascertain the facts and will make a detailed report of its findings.

181. *Id.* at 1-2.
182. *Id.* at 3.

> We, on the other hand, have agreed—based on the company's assurances and undertakings in this particular case—to "generic" disclosure pending the completion of the company's inquiry—that is to say, disclosure of the fact that certain improper payments in a general aggregate amount have been made in certain countries without requiring the disclosure of names and places. Of course, if a company is not willing to make such a declaration of cessation, we might have a different attitude, including an insistence upon disclosing that it is the policy of the company to obtain business abroad through bribing government officials.[183]

Among those factors identified by former Chairman Garrett, perhaps the most significant was the declaration of cessation. The *quid pro quo* implicit in Garrett's comment became evident when Chairman Hills testified before Congress on January 14, 1976. Hills reiterated the Commission's dedication to the voluntary program, noting it was flexible enough to cover most any situation. He went on to say:

> The company may then enter the "voluntary program" if the board of directors (1) declares an end to all such practices and (2) authorizes a complete investigation, both of all matters that have been discovered as well as of any similar activities involving the company (within or outside the United States) within the previous five years.[184]

Hills also outlined six categories of information germane to any filings under the voluntary disclosure program. These include a description of: (1) the amounts paid; (2) the purpose or character of the transactions in which payments were disbursed; (3) the role of management; (4) the tax consequences, if any; (5) the accounting treatment given these payments; and (6) the impact on revenues, income, assets or operations caused by a termination of the payments.[185] Finally, Hills repeated Loomis' earlier warning that the Commission was not estopped from bringing future injunctive actions merely because a company had made a "voluntary" disclosure. That the voluntary disclosure was not an "amnesty plan" was evident after Commission actions against General Tire[186] and Fire-

183. *Confidence in Business*, Address by Ray Garrett, Jr., in Madison, Wis., Sept. 12, 1975, at 16.

184. Statement of Roderick M. Hills, Chairman, SEC, *Hearings Before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee Congress*, 94th Cong., 2d Sess. 16 (1976).

185. *Id.* at 16-17.

186. Securities and Exchange Commission v. General Tire and Rubber Company, SEC Lit. Rel. No. 7386 (D.D.C., May 10, 1976).

stone,[187] both of which had made prior public disclosures of illegal or improper payments. It would appear, in other words, that the voluntary program and the enforcement program are not discontinuous, but rather reference points along a continuum.[188]

While it may be fatuous to draw generalizations about the voluntary program at this point in its development, certain facts seem clear. Without doubt, the program has been instrumental in providing an increased flow of significant information to shareholders, investors, and others. At least 100 corporations have filed voluntary disclosures concerning improper payments, a number of others have approached the staff of the Commission in preparation for such disclosures, and more will surely follow.

Through the voluntary program, shareholders have learned, among other things, that substantial corporate funds were paid directly to government officials; that secret contributions were made to foreign political parties; and, that secret payments were made to retain military protection for certain corporate activities.[189] Shareholders have also been advised that suspiciously large commissions were paid to various agents with little or no knowledge of, or accounting for, the actual use of the money.[190]

The voluntary program has also been used to report other kinds of improper conduct, including such matters as violations of foreign currency and exchange regulations and unauthorized transactions by foreign subsidiaries.[191] In other cases, registered companies have disclosed adjustments to tax liabilities, or the possibility of actions by the IRS as a result of questionable or illegal activity.[192] Some companies have even used the program to report domestic political contributions to shareholders.[193]

As a result of the voluntary program, moreover, officers and directors of public companies, their professional advisers, including attorneys and accountants, and all others involved in the disclosure process, have become more sensitive to the existence of improper payments and the conditions under which they are possible. To this

187. Securities and Exchange Commission v. Firestone Tire and Rubber Company, Civil No. 76-1064 (D.D.C. filed June 15, 1976), SEC Lit. Rel. No. 7443 (Jun. 17, 1976).

188. The possibility of enforcement action seems greater in those cases in which the company has commenced an investigation only after notification by the staff of possible violations. *Cf.*, Merck & Co., Inc. Form 8-K. (Dec. 1975), SEC File No. 1-3305; A-T-O Inc. Form 8-K (Jan. 1976), SEC File No. 1-5456.

189. SEC REPORT, *supra* note 22, at 16-35.

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.* at 3.

end, management has been encouraged to conduct its own investigation before being compelled to do so by a Commission complaint. These inquiries have often resulted in the termination of all improper or illegal payments.

Perhaps one explanation of the success of the voluntary program lies in its flexibility. Indeed, in practice, companies have not always adhered to the Cities Services model. The Commission itself has stated that this model is not exclusive:

> [I]t is important to note that there is no requirement that a company's disclosures concerning questionable payments be made within the framework of the program. Many registrants have simply made what they consider to be appropriate disclosure without consulting the Commission's staff.[194]

The requirement that volunteers issue "declarations of cessation" is indicative of this ambivalence. While the majority of those companies coming forward voluntarily have adopted policy statements prohibiting irregular payments, others have filed reports which are either equivocal or silent with respect to management's future intentions.[195] In fact, at least four companies have stated that they intend to continue making certain questionable payments in the future.[196]

Nevertheless, despite the demands of some that it adopt a mechanical approach to the problems of disclosure, the Commission has so far been unwilling to do so.[197] In its place, the Commission has employed a flexible regimen combining the virtues of selective enforcement and voluntary disclosure.

"Punched a Tar Baby"—Are There Solutions?

In this whole field of questionable or illegal corporate payments, the Commission at times must have felt as if it had "punched a tar baby"[198] from which it could not free itself. The question that remains at this point is: Where does the Commission go from here?

A number of alternatives were, and still are, available to the Commission. It could continue on an ad hoc basis with its already established program of injunctive actions and voluntary disclosure.

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194. *Id.* at 4.

195. *Id.* at 19, 21.

196. These companies are: Care Laboratories, Castle & Cook, Santa Fe International and Rollins. *Id.* at 11.

197. Some companies making questionable or illegal payments have apparently been excused from disclosure altogether. *See SEC's Fuzziness on What Illicit Dealings Should Be Reported Limits Disclosures*, Wall St. Jour., Mar. 29, 1976, at 26, col. 1.

198. Garrett, *Homily*, *supra* note 24, at 9.

It could promulgate disclosure guidelines which would require the detailing of such payments to investors. Finally, it could promote legislation which would govern the disclosure of illegal or questionable payments.

Ad Hoc Approach

The Commission, to date, has proceeded largely on an ad hoc basis. Injunctive actions have been brought on a case-by-case determination of the facts, and the voluntary program has continued to provide almost daily disclosures of illegal or questionable payments. Certain problems arise in continuing with an ad hoc posture. The Commission might well be criticized by litigants that there are no explicit disclosure standards in the area of questionable or illegal corporate payments. Defendants in these actions might argue that it is unfair to subject them to the ambiguities of a case-by-case approach without prior benefit of a Commission rule concerning such disclosure. However, it is doubtful that such an argument would be sustained in the courts. The Supreme Court has previously commented on the Commission's exercise of its rule-making powers in *Securities and Exchange Commission v. Chenery Corp.*[199] There the Court held that "the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency."[200]

Promulgation of Guidelines

The promulgation of guidelines concerning disclosure of questionable or illegal corporate payments was initially considered by certain Commissioners to be desirable.[201] Commission guidelines, it was thought, would satisfy the desires of the corporate community for clarification of the obligations which corporations must satisfy, reduce uncertainty, and establish the responsibilities of various participants in the registration and reporting process.[202]

199. 332 U.S. 194 (1947).

200. *Id.* at 202-203. *See also* Securities and Exchange Commission v. Bausch & Lomb, Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,825 (S.D.N.Y. 1974). *Cf.* Securities and Exchange Commission v. Sorg Printing Co., [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶ 95,034 (S.D.N.Y. 1975).

201. *See* Sommer, *supra* note 174; *The Uses of Disclosure*, Address by Ray Garrett, Jr., in Washington, D.C., Sept. 30, 1975, at 14.

202. The various participants in the registration process perhaps most desirous of a delineation of responsibilities include: directors, accountants, and attorneys. *See generally* Caplin, *Outside Directors and Their Responsibilities: A Program for the Exercise of Due Care*, 1975 J. CORP. L. 57. The Commission has most recently set forth its views on the duties of directors in *In re* Sterling Homex, CCH FED. SEC. L. REP. ¶ 80,219 (1975). *See also* AICPA Exposure Drafts on Illegal Acts By Clients and the Auditors Responsibility for the Detection of Errors

The promulgation of such guidelines, however, is fraught with pitfalls. The difficulties of definition, the variety of practices employed, and the impact of disclosure all present formidable barriers.[203] Beyond these difficulties, the Commission is continuing its enforcement actions, which involve issues to which any future guidelines would relate. A release or rule, for example, could impair present enforcement actions or deter future ones. A policy-oriented release which did not address the specific conduct of the defendant or potential defendant could suggest that the Commission did not view such behavior as violative of federal rules.[204]

Nonetheless, the Commission has made public a report on questionable and illegal corporate payments and practices. This Report provides a detailed analysis of the cases brought by the Commission and the specific disclosures made pursuant to the voluntary program. While not including guidelines per se, the Report does offer corporate managers and their professional advisors some guidance on the factors the Commission has considered significant regarding disclosure.[205]

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or Irregularities, BNA SEC. REG. & L. REP., No. 352, at F-1 (May 12, 1976). Jaffe, *The Outside Director: Standards of Care Under the Securities Laws*, 24 EMORY L.J. 669 (1975).

203. For example, the Lockheed payoff scandal prompted serious repercussion in Japan culminating in the arrest and indictment of former Prime Minister Tanaka. Wall St. Jour., Aug. 17, 1976, at 2, col. 3. The following summary was recently made as to the repercussions abroad from foreign payoffs by Lockheed and others:

> In Saudi Arabia, fewer foreign newspapers get past the censors.
>
> In Italy, the Communist party receives an unexpected lift closer to national power.
>
> In Japan, the ruling party is embroiled in the worst political crisis since the end of World War II.
>
> In Holland, the long-revered royal family suddenly faces a stormy future.

Wall St. Jour., March 18, 1976, at 1.

204. *See* United Housing Foundation v. Forman, 421 U.S. 837 (1975), where the Commission's promulgation of guidelines in the area of condominiums was used against the Commission's position taken in its amicus curiae brief. The Supreme Court noted that:

> Traditionally the views of an agency charged with administering the governing statute would be entitled to considerable weight . . . But in this case the SEC's position flatly contradicts what appears to be a rather careful statement of the Commission's view in [SEC Lit. Rel. 33-5347].

421 U.S. at 858 n.25. *See also* Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 425-26 (1972) (Commission amicus curiae); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (S.D.N.Y. 1969), *aff'd on other grounds*, 478 F.2d 1281 (2d Cir. 1973) (Commission amicus curiae); Securities and Exchange Commission v. Harwyn Industries Corp., 326 F. Supp. 943, 956 (S.D.N.Y. 1971); H. Kook & Co. v. Scheinman, Hochstin & Trotta, Inc., 414 F.2d 93 (2d Cir. 1969).

205. Former Commissioner Sommer, however, has been highly critical of the Commission's failure to issue guidelines, stating:

> [I]n my estimation the Commission has in one major respect failed terribly in carrying out its responsibilities: that is its failure to provide any significant guidance, other than what can be gleaned from the complaints in enforcement actions that it has commenced and the disclosures which it has required of issuers under

Perhaps the best guidance is given in the area of financial accountability. The Report considers that a disclosable event may occur where there is:

> The accumulation of funds outside the normal channels of financial accountability, placed at the discretion of one or a very small number of corporate executives not required to account for expenditures from the fund; the use of non-functional subsidiaries and secret bank accounts; and the laundering of funds or other methods of disguising their source or disbursement. . . .[206]

Other events which the Report concludes may give rise to a disclosable event include the following:

> (1) where the payment is illegal under local law;
> (2) where the payment is to a government official in an individual capacity;[207]
> (3) where the payment is to an agent or consultant and his relationship to the contracting party, the size and nature of the payment, the services to be performed and the method or manner of payment are considered;
> (4) where the payments are significant in amount or are related to a significant amount of business;
> (5) where the payments involve a pervasive pattern of encouragement, participation in, or knowledge of these practices by senior management;
> (6) where the payments involved the company's product or service which would not be successfully marketed in the absence of such payments.[208]

While the Report does not give any hard and fast rules on disclosure of questionable or illegal payments, it does provide a basic framework in which disclosure decisions can be made.[209] It appears,

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> the voluntary program, concerning matters which must be disclosed with regard to illegal or questionable overseas and domestic payments.

A Parting Look at Foreign Payments, Address by A. A. Sommer, Jr., in Columbus, Ohio, April 2, 1976, at 17.

See also Freeman, *The Legality of the SEC's Management Fraud Program*, 31 Bus. Law. 1295, 1299-1301 (1976).

206. SEC Report, *supra* note 22, at 7.

207. In this regard, differentiation should be made for the so-called "greaoe payments" made to low-level government officials to perform functions or services which they are obliged to perform as part of their governmental responsibilities, but which they may refuse or delay unless compensated. *See* SEC Report, *supra* note 22, at 7.

208. *Id.* at 5-8, which provides a more detailed analysis of items 1-6 set forth in the text.

209. The Report is not without its critics. A House Commerce Subcommittee staff report found "serious shortcomings" in the Commission's approach to the disclosure of questionable or illegal corporate payments. This criticism presents an opposite view from that of former Commissioner Sommer, *supra* note 205. The subcommittee report recommends that the SEC require increased disclosure from publicly-owned companies and that the agency ask for

however, that it is the Commission's view that any definitive rules governing the disclosure of questionable or illegal payments must come from Congress.[210]

Legislative Proposals

The area of illegal or questionable payments has obviously presented many thorny and controversial problems of national and international concern. As a result, various committees in Congress have considered the problem and the need for legislation. No less than five bills have been proposed to deal with these payments.[211]

Senator Church introduced a bill that would have amended the Exchange Act to require disclosure of foreign payments. It required changes in the internal operations of corporations to insure reporting of accurate information. Under the proposal, the State Department would have been required to provide an annual review and analysis of the foreign policy implications of these payments.[212]

This bill was followed by a proposal of Senator Proxmire, which originally would have prohibited the payment of bribes or kickbacks by U. S. corporations overseas and have granted to the Commission authority to initiate criminal action against firms violating the proposed prohibition.[213] In its original form, this bill received substantial criticism. Only a significantly revised version, the result of a compromise, passed through the Senate Banking Committee.

The Commission supported the philosophy underlying Senator Proxmire's bill, but drafted a modified version as a preferable legislative approach to the issues raised.[214] The Commission's proposal, in essence, would: (1) require management to establish internal controls that would reasonably assure that financial transactions are properly identified and recorded; (2) prohibit the falsification of any corporate accounting records; and (3) impose liability on corporate officers who make false or misleading statements to their auditors or who otherwise cause the financial condition of the corporation to be presented falsely.[215]

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additional enforcement staff in order to conduct a more vigorous investigation program on illegal payments. BNA SEC. REG. & L. REP., No. 354, at A-1 (1976).

210. *See* SEC REPORT, *supra* note 22. *See also* Interview of Roderick Hills conducted by the Bureau of National Affairs. BNA SEC. REG. & L. REP., No. 357, at AA-2 (1976).

211. Senator Church introduced Senate Bill 3379; Senator Proxmire submitted initial Senate Bill 3133; the Commission included a proposed bill in its Report; President Ford has drafted proposed legislation and the Senate ultimately approved. S. 3664, 94th Cong., 2d Sess. (1976). *See infra* note 216.

212. BNA SEC. REG. & L. REP., No. 352, at A-11 (1976).

213. S. 3133. *See also* BNA SEC. REG. & L. REP., No. 348, at A-15 (1976).

214. SEC REPORT, *supra* note 22, at 12-15.

215. *Id.* at 63-64.

The full Senate, however, ultimately approved legislation which incorporated portions of Senator Proxmire's initial proposal and that of the Commission. The bill includes the Commission's proposal concerning the maintenance of accurate books and records and the provision making it illegal to mislead outside auditors. In addition, for corporations subject to the reporting requirements of the Exchange Act, the bill

> applies to the existing criminal penalties of the securities laws (up to two years imprisonment and a fine of up to $10,000) for payments, promises of payment, or authorization of payment of anything of value to any foreign official, political party, candidate for office, or intermediary, where there is a corrupt purpose. The corrupt purpose must be to induce the recipient to use his influence to direct business to any person, to influence legislation or regulations, or to fail to perform an official function in order to influence business decisions, legislation, or regulations, of a government.[216]

The legislation would also apply the same prohibitions to domestic companies not under the jurisdiction of the Commission but would assign enforcement responsibilities to the Justice Department.

Whether this bill will be passed in its present form is uncertain. It does seem apparent, however, that some form of legislation concerning illegal or questionable payments will eventually be passed by Congress and signed into law.[217]

CONCLUSION

The Commission's present approach has provided a crude but realistic mechanism for balancing the needs of investors and the protection of American business operating overseas. In view of the theoretical and practical difficulties in formulating definitive guidelines, the Commission has thus far chosen a more pragmatic posture

216. S. Rep. No. 94-1031, S. 3664, 94th Cong., 2d Sess. (1976). Chairman Hills has taken the position that such broad legislation is not necessary in that questionable and illegal corporate payments can be effectively controlled under present Federal securities laws. BNA SEC. REG. L. REP., No. 360, at A-10 (1976).

217. President Ford, as a result of the findings of a task force he created, has also proposed legislation in this area. This legislation would require that the recipients of such payments be reported to an executive agency, rather than the SEC, and that the agency make available a report concerning such payments after a certain waiting period. The agency involved would be empowered to report the payment to the appropriate foreign government. Wall St. Jour., Aug. 4, 1976, at 4.

which places the burden on the issuer in exchange for the chance to escape the *in terrorem* sanctions imposed upon defendants in Commission enforcement actions.

Further refinement of the Commission's approach must await a legislative enactment which may clarify the ambiguities heretofore existing. Until such time as legislation is enacted, the Commission should proceed to foster disclosure of corporate conduct of material importance to investors, not peripheral matters which interest only the curious moralist.